

Personal Finance

Special Report

Five IDEAL Stocks for Any Market

by Jim Pearce and the IDEAL Team at Investing Daily's *Personal Finance*

For the past five years we have enjoyed almost uninterrupted growth in the U.S. stock market. Since its nadir in March 2009, the S&P 500-stock index has more than doubled. With such a massive move across the board, the odds were slim your portfolio would grossly underperform the market.

But we're entering into a new market phase now that the effects of the recession seem to be behind us. Major stock market indexes won't double, and many stocks won't appreciate along with the overall market. The market is much more fully valued.

Given this higher market valuation, we'll have more of a two-tier market, one with a roughly equal number of winners and losers. While the overall market grows, the difference between how the top half and the bottom half perform will be greater.

During my 30-year career as a stockbroker and financial adviser, I have developed a formula that can identify companies that will excel..

This "IDEAL" – Investing Daily Equity Analysis List" – system ranks all 500 equities in the S&P 500 according to three variables that are highly correlated to share price.

The first factor is **dividend yield**. Dividends have provided more than half the stock market's total return over the past fifty years. So a stock that pays a competitive dividend is more likely to appreciate in the future. My formula assigns a value on a scale of 0 to 3 to a stock's dividend yield.

The second factor, **growth in cash flow**, determines how well a company can afford to pay its dividend, buy back its own shares and continue to invest in the business. Unlike earnings, which can be manipulated to disguise a company's solvency, net operating cash flow reveals an enterprise's true health. A company's growth in net operating income over the past three years is assigned a value of 0 to 3.

The third factor is **relative value**. This tells us how a company's stock is valued versus the overall stock market based on its forward price-to-earnings

ratio. The future, estimated 12-month earnings is more useful than the trailing P/E in determining whether the current stock price is too high or too low. This "relative value" is assigned a value from 0 to 4 to reflect the extent to which a company's forward P/E ratio is fair compared with its peer group (we use the P/E ratio for that company's sector, since certain sectors historically trade at a premium or discount to the overall market).

The total score is on a scale from 0 to 10. The score tells us how a stock ranks for probability of future appreciation. And by assigning a current value to each company relative to its sector peer group, and then identifying buy limits and sell targets, it is even more useful. In addition to calculating the score for an individual stock, the formula also calculates a score for the entire S&P 500 index. We can compare the dividend yield, growth in cash flow, and P/E ratio compared with its historical value, just as we can for a stock. We can then compare the current value of a stock to how it compares with the current value of the stock market.

For example, if the IDEAL score for the S&P 500 index is 4, and the IDEAL score for a particular stock is 6, then that stock is undervalued by about 50% (in other words, the stock price could appreciate 50% before its total score declined to a 4, the same as the overall market). Conversely, if the IDEAL score for a stock is 2 compared with an IDEAL score of 4 for the index, then it is overvalued by 50%, meaning its stock price would have to drop in value by half before its total score was the same as the index.

I refer to this equilibrium stock price as the "IDEAL Value," since it reflects the exact price that would cause that stock to be neither undervalued nor overvalued. Therefore, the IDEAL Value of a stock is the current price that would give it the exact same total score as that of the entire index. Using the example above, if a stock that is priced at \$50

has a total score of 6 while the index has a total score of 4, then its IDEAL Value would be \$75 ($\$50 \times 6/4$).

Put another way, based on my formula it has upside potential of about 50% over the next 12 months, assuming the overall stock market remains unchanged and nothing else changes.

Of course, the stock market does change, and my formula constantly adjusts scores so you always know how each stock rates at any time. You don't need to wait until next week, next month or next year to find out if our valuation of a stock has changed – you can find out right away by visiting the Portfolios tab of the *Personal Finance* website.

If you're at a time in life when you need rock-solid high performers, the IDEAL system will identify them for you. Here are five IDEAL stocks that will help you erect a wall around your wealth by giving you a set of assets that should prosper no matter what happens to the economy.

1. Chevron

Chevron (NYSE: CVX) is a multinational energy company operating in more than 180 countries. It is the second-largest oil company in the U.S. and one of the 20 largest public companies in the world measured by market capitalization. Its roots go all the way back to the 1870s when oil was discovered near modern-day Los Angeles. In the early 20th century, one of its predecessors merged with a division of Standard Oil to create the Standard Oil Company of California, which later became Chevron.

Today the company operates primarily in two segments: upstream and downstream. The upstream segment is involved in the exploration, development and production of crude oil and natural gas. The downstream segment engages in refining crude oil into petroleum products, and marketing crude oil and refined products primarily under the Chevron, Texaco and Caltex names.

The company is also involved in diversified activities such as coal and molybdenum mining, cash management and debt financing activities, insurance, real estate, energy services and alternative fuels and technology businesses. Chevron also boasts 13 assets with a total operating capacity of approximately 3,100 megawatts.

Chevron is well-positioned for long-term growth using its cash flow to invest for the future. It

has been transitioning the company from mostly oil production, refining, petrochemicals and gas stations to more of a balance with natural gas and liquefied natural gas (LNG), as well as focusing on growth in the Asian markets as there is rapid demand growth there for oil, natural gas, LNG and other petroleum products. Management is expecting about 20% output growth and plans to achieve this by 2017 by focusing the company's attention on growing natural gas production, LNG projects and other value-added projects in the oil and natural gas industry that focus on the massive demand growth for hydrocarbons in the Asian markets.

The firm boasts a five-year average dividend yield of around 3%, and a very low dividend payout ratio. It has boosted its dividend for nearly 31 consecutive years. Chevron's balance sheet shows over \$7 billion in cash and \$35 billion in long-term debt, which is a safeguard for any sudden economic downturn.

2. Chubb Limited

Chubb Limited (NYSE: CB) is one of the world's largest property and casualty insurers, and operates in 54 countries. It was formed out of the merger between Chubb Corporation and ACE Limited, completed in January 2016.

Prior to the merger, ACE had outperformed both its domestic and international peers in return on equity over the past 10 years by 1.5% and 2.9% respectively, and had increased its annual dividend for 22 consecutive years. ACE's stock soared 120% over the last five years.

Founded in 1985, and headquartered in Zurich, Switzerland, ACE Limited provided a variety of insurance, including commercial, personal property, casualty, accident and life insurance.

ACE looked to expand business further into Asia and Latin America. It had been able to nearly double its gross written premium (a measure of performance) in Asia from \$1.6 billion in 2009 to \$3.0 billion in 2014. It had similar success in Latin America, increasing its gross written premiums from \$1 billion in 2009 to \$2.9 billion in 2014.

Meanwhile, Chubb Corporation shares were up by more than 30% following the announcement that it was to be acquired by ACE Limited for \$28.3 billion in cash and stock. When the deal closed in January 2016, Chubb shareholders received \$62.93

in cash and 0.6019 shares of the new CB stock, a total of \$124.13 per share.

The deal combined two of the largest insurers in the U.S. and is the largest ever tie-up in the insurance industry. Property-and-casualty insurers have been struggling against falling premium rates amid tough competition in the sector even as low interest rates have pressured investment income. By combining operations, the two companies will save about \$650 million in expenses in a deal that will be immediately accretive.

We believe the deal makes solid strategic sense. While some lines of business will probably have to be divested, we don't think it will have a major impact on the company's revenue or earnings.

3. IBM

There was a time – not that long ago – when **IBM** (NYSE: IBM) was synonymous with cutting edge technology. It could reliably count on being able to hire the best and the brightest from all over the world to ensure that it maintained its position atop the tech sector. But what it did not count on was the degree to which the tech sector would quickly evolve away from the very machines that enabled to grow so fast in the first place.

Although there is no one salient event that can be blamed for IBM's swoon, the demise of its server business due to much cheaper x86 blades used on Windows and Linux operating systems forced the company into abandoning the one remaining piece of the hardware business it had left after its PC business was overtaken by Apple during the previous decade.

That left the company with only one clear path out of the woods; selling consulting services to customers with complex needs that only a company the size of IBM could deliver as a single source. But even that piece of the business was challenged by more specialized competitors providing similar services at a lower price. IBM realized it needed to come up with something truly unique, and that thing is "Watson."

Most people know Watson as the computer that beat Jeopardy game show legend Ken Jennings in 2011, viewing that accomplishment as little more than a clever parlor trick. However, Watson is much more than that, defined by IBM as "a technology platform that uses natural language processing and

machine learning to reveal insights from large amounts of unstructured data."

The reason that's important is that approximately 80% of all data today is unstructured, meaning it must first be organized before it can be analyzed. And in order to analyze that data, someone or something must first be able to recognize it, categorize it, and then interpret it correctly in a short period of time for it to have economic value. Otherwise, it's just a bunch of useless junk sitting on a computer.

Unlike you and me, Watson never forgets a fact once it learns it, and it is capable of digesting an almost infinite amount of data to help it solve a problem. All of that evidence is scored according to an algorithm based on its relevance to the question posed, and then Watson selects the most likely correct answer. Watson is sometimes described as being like "Google on steroids", but in fact it is much more than just a very powerful search engine.

In simplest terms, Watson is a problem-solving machine capable of providing solutions to extremely complex problems in a very short period of time. The potential applications are limitless: healthcare providers can more accurately and quickly diagnose medical conditions; product vendors can pinpoint inefficiencies in their manufacturing process to maximize profitability; and large organizations can streamline their cost structures to minimize waste.

You may have seen a commercial on television recently showing music legend Bob Dylan having a conversation with Watson to illustrate its language skills (Watson: "I can read 800 million pages per second"; Dylan: "That's fast"). The point of the ad is to illustrate how fluid Watson can adapt to verbal input, which is another feature of Watson that makes it easy to use. You ask it a hard question, and it immediately responds with a good answer.

It's premature to say if Watson will turn out to be the savior IBM thinks it is, but it does appear that the worst may be behind IBM, at least in terms of operating cash flow which is the fuel that drives future growth in earnings. Since bottoming out in March of 2015, operating cash flow has climbed steadily. Although still far below its peak levels from four years ago, at the current pace IBM will be producing cash flow at 2011 levels within a year. It's worth noting that IBM's IDEAL Value suggests

it has plenty of room to appreciate before approaching fair value.

4. Verizon Communications

Money: That's the critical element for success in the rapidly evolving communications business.

And few have more of it than **Verizon Communications**, which spent \$16 billion for network expansion, upgrades and spectrum in 2013.

That's a rate only archrival AT&T (NYSE: T) can match.

The company leads in U.S. wireless customers and, more importantly, it has more post-paid contract customers than any of its competitors. And more than half of them have smartphones.

With each passing day, Verizon is extending its lead over rivals in reliability, capacity and speed, including the rollout of fifth-generation (5G) wireless long-term evolution (LTE) technology.

Its 30-year debt yields barely 4% to maturity, the industry's lowest cost capital.

Verizon also has an agreement to pay four cable television giants a total of \$3.9 billion for currently unused wireless spectrum, with the parties also becoming agents to sell each other's products and services.

Verizon has consistently raised its generous dividend.

Verizon's LTE network clearly leads the market, covering about 80% of the U.S. population, roughly 250 million people. Verizon's money

power assures growing revenue, earnings and dividends for the foreseeable future.

5. Wells Fargo

Wells Fargo & Co (NYSE: WFC) is one of the nation's four largest banks after doubling in size from its 2008 acquisition of Wachovia Bank and sailing through the financial crisis mostly unscathed. The company boasts more than 9,000 retail branches in 39 states.

It's also one of the country's largest mortgage lenders and is set to benefit greatly from the recovering housing market.

The bank enjoys numerous competitive advantages over its peers, including the ability to fund its assets at a much lower cost than the others; its strength at cross-selling products and services to customers; and consistently superior financial performance, including return on assets, return on equity and low loan write-offs.

Also, Wells Fargo stands to benefit from the impact of higher interest-rates caused by potential Federal Reserve monetary policy.

Despite the company's fake customer account scandal late in 2016, shares of Wells Fargo have rebounded and will continue to rise as quarterly earnings reports reveal minimal financial impact.

Wells Fargo trades at a reasonable price, considering it's the strongest among its peers. This company is a conservative total-return investment on a gradual economic recovery.

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