Private Opportunities Club

Your Window Into the World of Wealth

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Key Points

- Time to Wade Back Into Housing Waters
- Home Prices Starting to Edge Up
- Housing Recovery Won't Be Smooth
- Home Improvement Retailers Benefiting

Plus

- Consider Technology Dividend Stocks
- Explore Upstream Natural Gas Plays
- Gas Markets Poised for Takeoff

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This month's password is: economy

(Please remember to use lowercase letters.)

Housing Recovery Unveils Opportunity, But Be Careful

By Forrest Jones

The massive U.S. housing sector, which threw the economy into the worst downturn since the Great Depression and continues to weigh on its recovery, is finally showing signs of life.

The S&P/Case-Shiller 20-city index of home property values rose 3 percent year-over year in September, after gaining 2 percent year-over year in August.

Data measuring housing starts and sales have shown similar gains, while big investors seem to be positioning themselves for recovery.

Warren Buffett, CEO of Berkshire Hathaway, for one, has spearheaded the creation of Berkshire Hathaway HomeServices, which will combine networks of more than 53,000 Prudential Real Estate and Real Living Real Estate agents.

Financing, however, remains tight for many people, which is keeping reasonably priced homes out of their reach.

Add to that, many homeowners are underwater with the equity on their property and are unable to sell their homes. If prices continue to rise, those underwater homeowners might work up the nerve to put their houses on the market, meaning the inventory of homes for sale would increase and cap whatever gains home prices have made up to now.

Furthermore, millions of homes are in some stage of foreclosure and will make their way to the market.

Bottom line: By its nature, the housing market takes a while to bottom out and improves in a stop-and-go manner. Still, the market appears to be on the other side of the abyss, which will allow for some attractive investing opportunities over the long term for many people — even without buying a home.

Take home-improvement retailers.

Home Depot stocks are trading around $64 these days, just shy of $65.92, the upper limit of a 52-week trading period and well above a low of $38.84.

Lowe's, meanwhile, is trading around $35 these days, just below $36.47, the upper limit of a 52-week trading period and well above a low of $24.04.

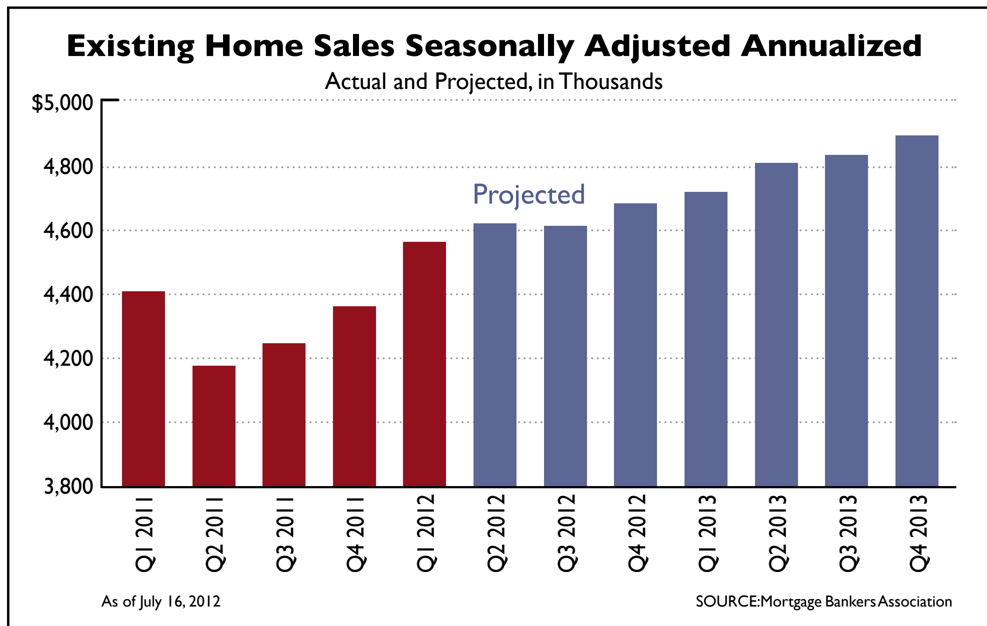
Investors have been snapping up shares in those companies and others that benefit from a housing recovery either outright or via exchange-traded funds, such as XHB (SPDR S&P Homebuilders ETF), ITB (iShares Dow Jones US Home Construction Index), and PKB (PowerShares Dynamic Building & Construction Portfolio).

Home builders such as Lennar and Toll Brothers are seeing similar trends.

"That means that smart people have been seeing this housing recovery coming and they have already been buying them," said Scott Weingarden, an associate vice president of Raymond James in Miami, Fla.

"It's already more than doubled in the last year. I don't know where it will go from here, but certainly you can argue that easy money has been made in a Home Depot investment based on a housing recovery," Weingarden added.

"It doesn't mean they can't go up more."



Even though home prices are improving in fits and starts, people still need a place to live, which has made the rental market attractive in recent years.

In fact, global private equity giant Blackstone Group has launched its Invitation Homes program, a new vehicle that purchases and refurbishes distressed single-family homes and then leases them out across the country.

"Every time they buy one of these houses, likely they are going to have to put new carpet in or paint them, with landscaping, all that stuff, which goes to Home Depot certainly," Weingarden said.

While the housing market may not boom any time soon like it did during the past decade, eventually, it will gain steam and possibly give way to a vibrant new asset class — a single-family Real Estate Investment Trust (REIT).

"What I also think is going to happen is that this is going to be a new REIT asset class one day. I don't know if it is in a year from now or five years from now, but if these people do this right, they could take these and make them public entities eventually," Weingarden said.

"Then everybody would have access, just like everyone today can invest in apartment REITs, they would be able to invest in residential housing REITs, or single family REITs.

"I think one of the goals of these companies that are doing this is to have an exit strategy for at least a portion of what they are doing."

The initial investment play on a housing recovery may be a missed opportunity for now, at least for short-term investors.

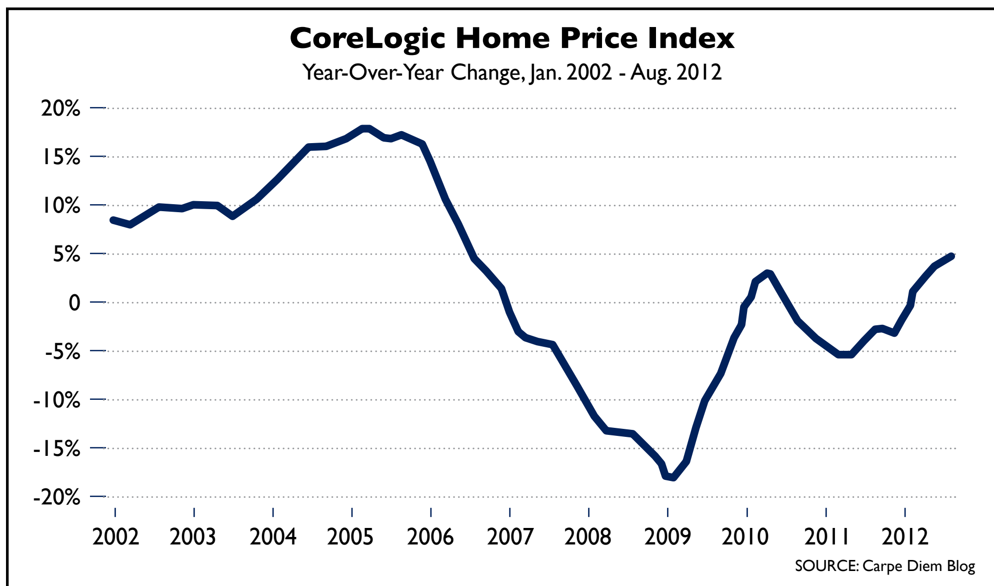
Yet other market participants agree that despite recent gains in home improvement retailers and home builders, the sector still has room to improve eventually.

"In general, I think we are likely to see the housing sector to continue to improve modestly over the near term and actually, over the medium term as well. We think that the pace of improvement this year has actually and partially been driven by a lot of investors and speculators," said Michael Souers, an equity analyst at S&P Capital IQ.

Home Prices Starting to Edge Up

Foreclosures have slowed somewhat as it takes banks longer and longer to process them, in some states even longer depending on their rules and regulations, which has kept prices up somewhat for now.

"There are a lot of factors that are limiting the overall supply of homes, and it's forced up an increase in home prices and driven increases



in new home sales and starts that are probably greater than what they should be at this point of recovery," Souers said.

"We are a little bit more cautious on the housing recovery. In terms of the home building segment and home improvement segment, I am actually kind of neutral to negative on that group. The share prices have already reflected this strong improvement and then some, so I am actually recommending that investors kind of pull back their position in those segments."

Still, there are opportunities to be found

"I am positive on Bed Bath & Beyond. I have a 'buy' on them. In terms of valuation I think the stock looks very attractive and really hasn't benefited from this uptrend in housing," says Souers.

"There are some things investors can look at, but in general, I think that overall the trade has kind of been played out."

While the sectors remains poised for further recovery, expect hiccups along the way.

Labor Market Holding Back Housing Recovery

"It's not going to be a smooth and rapid increase in housing. We are going to see a kind of start-and-stop recovery over the next couple of years," said Souers.

One factor dampening the housing recovery and all the sectors that serve it can be found in the labor market.

Companies are hiring more and more these days, but not at a pace quick enough to spur more overall economic growth that would take the overall housing sector up with it.

Many economists have said the country must add double the number of jobs created each month nowadays to absorb those out of work on top of those entering the labor market for the first time, such as recent college grads.

Furthermore, those who are finding jobs aren't likely to rush out and buy homes.

"If you look back over the last three years, about 5 million jobs have been created but 3.7 million of those jobs were actually for people who are 55 years old or older and only 185,000 were for people who were between the ages of 25 and 54 where you would likely see household formation being generated," said Souers.

"There are still issues in terms of job growth and that's likely to keep kind of a lid on how fast this recovery will go."

Others say the housing market isn't improving on its own two feet but has been propped by the Federal Reserve and government housing agencies such as mortgage giants Fannie Mae, Freddie Mac and the Federal Housing Administration.

Since the downturn, the Federal Reserve has taken the lead to spur recovery, namely by cutting interest rates and jolting the economy with other tools such as quantitative easing rounds, which are asset purchases the Fed makes from banks to inject the economy with liquidity.

The Fed is currently running a third round of quantitative easing under which the U.S. central bank will buy $40 billion in mortgage-backed securities held by banks a month to incentivize investing and hiring by pushing down borrowing costs across the economy.

As a result of present and past rounds of easing, mortgage rates are at rock-bottom levels.

"I happen to believe that the housing improvement that we have seen is artificial, that it's driven primarily by two factors, number one being the Fed buying north of $1 trillion worth of mortgage-backed securities over the last couple years to drive mortgage interest rates down to an artificially low level," said Charles Smith, CIO, founder and manager of the Fort Pitt Capital Total Return Fund. The other is that "90-92 percent of the mortgages underwritten today are guaranteed by either Fannie, Freddie or FHA — there basically is no private mortgage market that is not backed by the federal government.

"The fundamental question I ask is where would mortgage rates be if the Fed, Fannie, Freddie and FHA weren't in the marketplace, and my answer is a 30-year mortgage would probably be north of 8 percent."

While the economy may be awash in liquidity, many banks are keeping purse strings tight, still wary of lending in wake of the financial crisis four years ago.

Cash buyers, however, have been active, be they hedge funds or overseas investors buying residential properties in cities such as Miami or New York.

Such a trend gives home improvement retailers an edge over builders.

"I think you have to separate the public builders from the home improvement companies," Smith said.

"I think some of the benefit to the home improvement names, the Lowe's and the Home Depots, is happening because we have these large waves of cash buyers who are coming in and spending a certain amount to improve these places to get them ready to rent. I think that is helping the businesses for people like Home Depot and Lowe's."

Still, home improvement retailers owe their rising stock prices to other factors such as cost-cutting measures.

"I think the improvement in Lowe's and Home Depot has more to do with changes with inside the businesses. They are consolidating and doing what they need to do in terms of getting their costs in line more than anything else. I don't think that it's a fundamental improvement in housing so much that's driving Lowe's and Home Depot," Smith said.

That means investors need to be careful, as gaining housing prices stemming from monetary policy don't reflect improving fundamentals.

"We believe there is so much artifice in the system in terms of policy support that you can't take these low, single-digit, year-over-year increases in home prices to the bank. There's a certain amount of artifice there and you need to be careful," Smith added.

"It's not going to be a smooth and rapid increase in housing. We are going to see a kind of start-and-stop recovery over the next couple of years."

— Michael Souers

Others agree that the play in home improvement companies has passed, though over the long term, the future looks bright.

"In the near term, both Home Depot and Lowe's shares are slightly overvalued, in our view, let's say 5 percent overvalued, so it's not by any stretch really overvalued where you would want to avoid an investment. But instead, if we're looking at a margin of safety and having a big enough discount to our fair value estimate, you may not just want to put new money to work in those names unless you do think that 2013 and maybe even 2014 are going to be materially better from a U.S. housing standpoint," said Peter Wahlstrom, an analyst at Morningstar.

"A lot of the signs are heading in that direction, but it's probably a bit too early to really call the magnitude of how good 2013 could be. But there seems to be, in our view, a pretty fair amount of good news that is currently baked into the stock prices."

For the investor wishing to buy and hold over the long term, however, the future looks brighter.

"For the long run, we give both Home Depot and Lowe's a wide economic moat." ■

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Leverage Technology Dividend Stocks for Added Income

By Dan Weil

More technology companies are paying dividends, creating a new opportunity for income-oriented investors.

The Standard & Poor's 500 Index contains 71 technology stocks, and 42 of them sport dividends.

As of August, technology stocks accounted for 14.2 percent of the S&P 500's dividend payouts, exploding from less than 6 percent in 2007. That puts the tech sector at the top of the index, followed by the more traditional dividend industries — consumer staples, financials, healthcare, and industrials.

The tech dividend payers, which include Apple, Microsoft, Intel, and IBM, are adjusting to their slower growth modes. "This is partly a reflection of where these companies are in the growth cycle," says Mick Heyman, an independent financial adviser in San Diego.

"As they are maturing, they don't need all of their cash for research and development and [investing in] new ideas. That allows them to pay dividends." The dividend payments can be viewed as a good or a bad thing, Heyman points out. "It's good for those who want dividends, but not as good for those who want dynamic growth."

Many investors are coming to accept the slower-growth path, says Michael Sheldon, chief market strategist at RDM Financial Group in Westport, Conn. "There used to be a stigma attached to tech companies paying dividends — that they had lost their growth mojo. But times have changed."

To some extent, tech companies are responding to the needs of investors, says Josh Peters, a dividend stock analyst at Morningstar research firm. "As baby boomers move toward retirement, they want income," he says.

"The emphasis on capital gains of the 1980s and '90s has given way to an emphasis on dividends. That affects every sector of the market. But it affects tech more, because it hasn't been known for paying much historically. Some tech companies are rising to the challenge."

Ironically enough, thanks to investors' strong thirst for yield, many utility companies are trading with higher price-to-earnings ratios than tech companies such as Microsoft and Cisco, Peters notes. "As dividend policies

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Look Before You Dive Into Technology Dividend Stocks

By Dan Weil

If you're looking to dive into technology stocks that pay dividends, how should you make your selections?

"Assess the quality of the business first," says Josh Peters, a dividend stock analyst at Morningstar research firm. "Even a good dividend doesn't turn a bad company into a good investment."

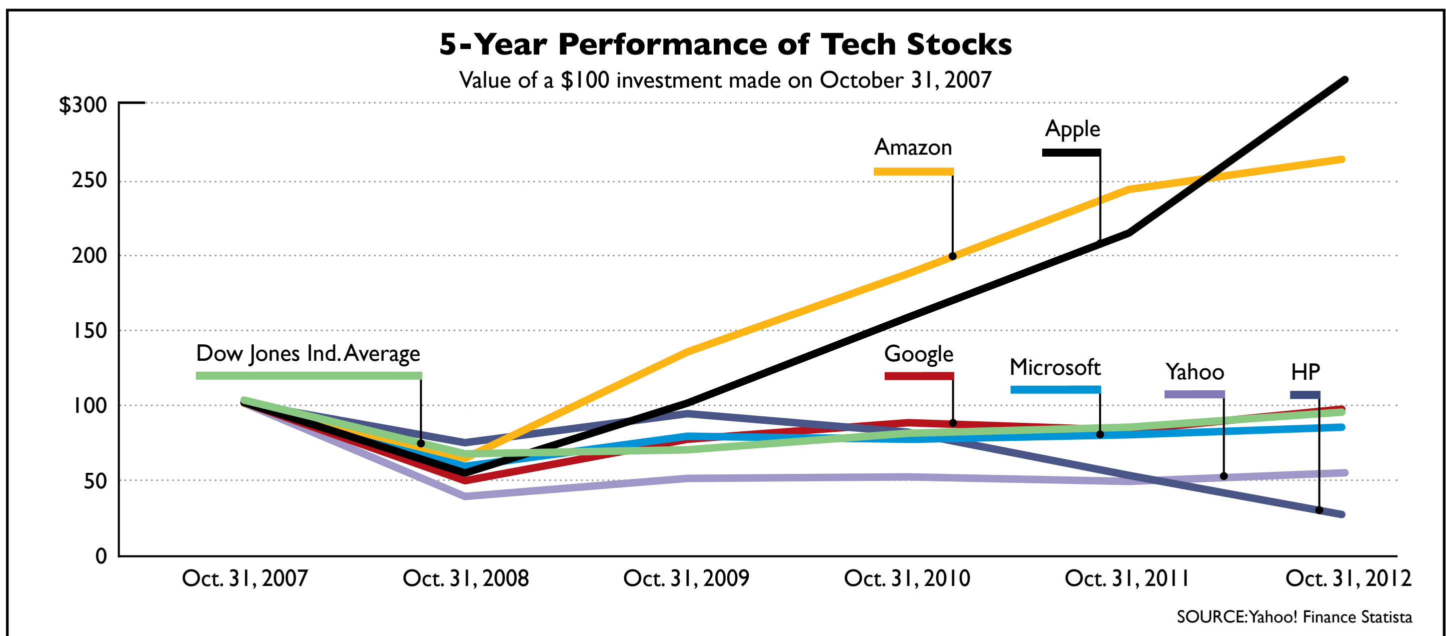
He recommends companies "with a solid franchise that can maintain market share with good margins and return on capital." Then look at how the company allocates its capital – how much to dividends, how much to acquisitions, etc. – and valuation. "There are a lot of cheap stocks in technology," Peters says.

If you can research individual companies, it's probably best to buy individual stocks. If not, you can choose a dividend stock mutual fund or exchange-traded fund (ETF) that includes technology names.

Mick Heyman, an independent financial adviser in San Diego, likes a combination of two different kinds of tech dividend stocks. One is companies with high dividends that are well-covered – value plays. The other is companies whose dividends aren't high, but can grow substantially over time.

In the first category, Heyman recommends **Intel (Ticker: INTC)** and **Linear Technology (LLTC)**, an analog semiconductor maker. In the second category, he recommends **IBM (IBM)** and **Apple (AAPL)**.

The stocks in the second category have dividends lower



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continue to mature, they provide an opportunity for companies to get higher PE multiples," he says.

"They should look at their capital allocation and conclude there can't be growth at any cost. They have to deal with maturing gracefully rather than living in the past."

Peters and others expect that more tech companies will offer dividends and that they will increase their dividends over time. Given that investors reward companies which boost their dividends each year, tech companies have incentive to do so, Heyman says.

"I would think tech companies would create a trend of not paying too much, so they can raise dividends modestly each year, or at least leave them the same."

Peters says annual percentage increases will likely register in the high-single- or low-double-digit range. The one fly in the ointment could be a change in tax policy, he and others say. A big increase in dividend taxes could stifle payouts.

But aside from that, it's a positive story for tech dividend stocks. ■

than the first, but the second-category companies also have higher earnings growth, so they should be able to grow their dividends faster, he says.

"If Apple continues its growth, there could be a dramatic yield on your cost basis five, 10, 15 years down the road. It looks like such a cheap stock right now [late November]," Heyman says.

Michael Sheldon, chief market strategist at RDM Financial Group in Westport, Conn., also likes Apple. RDM has bought Apple and **Qualcomm (QCOM)** for its customers. They both have strong fundamentals thanks to the strength of the smartphone industry, he notes. Qualcomm makes cellphone chips.

"Even though smartphone sales already have risen strongly over the past couple years, there is still a lot of growth to be had, particularly in emerging markets, over the next few years," Sheldon says. Qualcomm expects smartphone sales to show a compound annual growth rate of 24 percent between 2011 and 2016, he says.

For Morningstar's Peters, Intel represents the lone tech dividend stock he has recommended over the last few years. "It's the only large-cap tech company that has figured out the capital allocation process," he says. "It's in a deeply cyclical industry with high capital requirements. But its dividend balances against those other factors."

While Intel lags in providing chips for smartphones and tablet computers, "it has a lock on the server and PC business," Peters says. "And it has returned cash to shareholders without putting the dividend so high that it risks being cut during a down-cycle." ■

Upstream Natural Gas Play Equals Big Moneymaking Opportunity

By Julie Crawshaw

At first glance, it could seem that the sheer abundance of natural gas in the United States would make investing in it less of a moneymaking opportunity than investing in oil. But appearances can be deceiving, and this one is decidedly so, says Jonathan M. Bergman, CFP, managing director of TAG Associates.

"There are ways to make a lot of money on it, and today's price is a great entry point," Bergman says.

A barrel of oil produces six or seven times as much energy as a BTU of natural gas, so you would think the price of oil would be six to seven times higher than the price of natural gas as well.

But the reality is surprising.

"Right now that ratio is 24 times," Bergman says. "Natural gas is about $3.65 per BTU (U.S. price) and oil is $87 a barrel (global price), so either oil is overpriced or natural gas is underpriced."

Upstream Companies Offer Best Bet

TAG clients benefit from a proprietary custom portfolio of natural gas stocks, also referred to as "upstream companies," focusing on high-quality, low-cost exploration and production (E&P) companies. "This will be volatile, but we think this portfolio could double or triple over the next five years," Bergman says.

Investors should focus on choosing companies using those same benchmarks.

Alternatively, First Trust ISE Revere Natural Gas (ETF) is a good choice for investors who don't want to compile a portfolio of natural gas equities.

Bergman emphasizes that the best investing opportunities in the natural gas market are found in the upstream companies. He advises investors to look for growth, not yield. "Upstream is a bullish bet on long-term demand," he says.

"There's a tiny yield, but yield isn't the point

of buying it," he emphasizes.

Investing in midstream natural gas companies is another story, and not one Bergman thinks investors should read.

"I think there's a lot less money to be made there because midstream has been a yield play, and yield plays on every asset on the planet have been bid up very high," Bergman says.

"Midstreams are not necessarily trading at their fundamental values because too many people bought them for the wrong reasons and drove up the price, which increased their depreciation risk."

Gas Markets Poised for Takeoff

According to the 2012 World Energy Outlook, published by the International Energy Agency, the natural gas market is set to boom.

The IEA report states, "In the United States, low prices and abundant supply see gas overtake oil around 2030 to become the largest fuel in the energy mix."

Bergman says that the exporting of natural gas to Europe and Asia, where prices are far higher because there is little native supply of the commodity, is another excellent reason to buy E&P shares now.

The IEA report further supports that, projecting that United States will become the world's largest exporter of natural gas by 2020.

Though the technology used to unlock shale gas has caused dissension between environmentalists and E&P companies stateside, natural gas remains politically popular and consumption continues to grow at an increasingly healthy rate.

Many utility companies have switched or plan to switch to natural gas to avoid the environmentally less desirable power sources of coal and nuclear plants. State and municipal governments have switched their bus fleets to natural gas, as have some trucking companies.

"Electrical utility demand for natural gas has nearly doubled over the past decade," Bergman says. "Most new electrical generation facilities are powered by natural gas now."

Natural Gas Uses Growing, Expanding Opportunities

An added bonus is coming from chemical and fertilizer manufacturers, which use natural gas as a raw material. Many are suddenly finding that the United States is an attractive place to put new factories, bringing new jobs and more prosperity to the economy.

"I think that natural gas is one of those investments about which people will say, 'Of course it made money' years from now. It's just so obvious."

— *Jonathan Bergman*

Dow Chemical has made public a list of 91 new manufacturing projects proposed by various companies that offer $70 billion in potential investment and up to three million jobs.

Manufacturing plants are also expanding to make use of the low cost natural gas as feedstock, and plans are in the works to build more LNG export facilities.

Just one case in point: Clean Energy, in which commodity billionaire T. Boone Pickens is the main investor, recently agreed to buy two GE-made MicroLNG plants to provide liquefied natural gas for a network of 70 natural gas fueling stations it is opening at truck stops along U.S. interstate highways this year.

"We currently have some LNG production facilities, but the country is going to need more," says Clean Energy CEO Andrew Littlefair. "These two plants are critical in our next phase (of expansion) and we are going to need more plants over time."

Sasol, a South African energy company, has announced plans to build America's first commercial plant to convert natural gas to diesel and other liquid fuels using its proprietary technology that requires no oil.

"I think that natural gas is one of those investments about which people will say, 'Of course it made money' years from now," says Bergman. "It's just so obvious." ■