A Publication of Newsmax & Moneynews

The High Income Factor

Unlocking Powerful Strategies to Achieve Superior Returns

Tom Hutchinson, Editor

Vol. 4, No. 2 / February 2014

Pivot From Peril With an International Powerhouse

Major league baseball may seem a billion years away, thanks to this cold winter — I had never before heard the term "polar vortex" thrown around the local weather forecast — but pitchers and catchers report to spring training the first and second week of February.

It's an exciting time for baseball fans. Everyone's hopeful. Even Cubs fans dare to dream, if only for a moment, that "this could be their year." Every prospect is a future major league talent; every free agent signing is the catalyst to a 100-win season. The sun is shining in Arizona and Florida on all 30 teams.

Then, however, the pundits step into the fray. The rankings and overviews and prognostications start to separate the good from the bad before the first opening day pitch is thrown. By the time April rolls around, we all have a pretty good idea of what we can expect from our team.

Those expectations, though, can be interesting things. In many ways, they set the stage as to how we gauge our experiences.

Say the New York Mets, a chronically befuddled team near my neck of the woods, is expected to have a lackluster 72-win season and miss the playoffs by a wide margin. So as a fan, you go in with tempered expectations. Over the season, perhaps the Mets will surprise us and stay in wild-card contention until the final few days. All in all, fans, the media, and the team brass might look back on that as an accomplishment, an unexpected thrill that came up just a little short.

Now, consider the New York Yankees — with the astronomical payroll and the larger-than-life expectations, year after year. Any season that doesn't end in the World Series is a failure. You go in thinking like that, however, and you would have been pretty depressed as a fan most of the past decade. Since the team's epic run of titles, four in all from 1996 to 2000, it's won only one world championship since, in 2009. In Yankee terms, it's been a disaster.

> "For the first time since the financial crisis, the collective investor psyche is one of high expectations."

So, then, what to make of expectations currently taking shape in another realm beyond sports — that is, the high expectations in the financial markets for 2014?

For the first time since the financial crisis, the collective investor psyche is one of high expectations. Instead of a cautious but tempered optimism of a Mets fan, many investors are attaching Yankees-style expectations to this market.

To be sure, there is reason for optimism. Clear evidence exists that the economy is strengthening and may finally be turning the corner, from a sluggish recovery on artificial life support from the Federal Reserve (in the form of quantitative easing) to a more self-sustained and healthy prosperity.

Most analysts are expecting substantially stronger economic growth this year than last year. And for the first time since the financial crisis, most prognosticators and individual investors

are optimistic about the stock market in the year ahead.

Such good news is welcome, but it also raises the stakes. Stocks prices have moved a lot higher already and now have plenty to live up to. The higher the expectations, the greater the chance of disappointment . . . and a disappointed market equals falling stock prices. Good news has increased the risk.

But in the vast expanses of today's markets, there are places where expectations aren't so high yet. In certain parts of the world, stock prices are lower and less is expected. This presents an opportunity to find untapped value internationally.

"Last year's market returns were reminiscent of another era, that heady time when tech stocks were king."

By being on the right side of the expectations game, we can greatly reduce risk and increase our chance of investing successfully. This month, I found a powerhouse international stock that is among the best of its kind in the world. But this stock has not moved up nearly as much as its American counterparts.

I believe it is this company's turn to move higher. Through it, we can secure a stable and growing income stream, as well as a strong possibility of capital appreciation.

And in the case of this stock, I think the ceiling is much higher than the Mets' chances in 2014. For that team, one can only hope for a minor miracle — for our stock pick, however, we have the power of fundamentals proving its value.

Indeed, it's a championship-caliber addition to our lineup, which I'll get to soon. First, I'd like to delve further into the market as a whole to see, well, what we can expect going forward.

First, the Good News

"We haven't had that spirit here since 1969." So sang the Eagles in their well-worn hit "Hotel California." It kind of reminds me of today's market environment, except in this case, it's not '69, it's more like 1999.

Last year's stock market returns were reminiscent of another era, that heady time when tech stocks were king (right before the bubble burst in 2000). The S&P 500 index returned 29.6 percent in 2013, its best performance since 1997. The Dow Jones industrial average returned 26.5 percent, which is that index's best performance since 1995.

The best performer of all, however, was the Nasdaq, at 38.3 percent for the year.

For the first time since the recession following the 2008 financial crisis, individual investors are generally bullish about the market, mainly because the economic news has been so good. Such a positive consensus opinion about a stronger economy in the year ahead has not happened for years. The overwhelming majority of analysts are calling for a stronger U.S. economy over the course of 2014.

Here's a recap of some of the recent positive indicators:

- **Purchasing managers index (PMI)**

This measurement of industrial output is used to gauge manufacturing activity. The number for November was 57 (anything above 50 implies expansion). This was the second-highest reading in the past two years, and the number has risen for six consecutive months prior to November.

- **Third quarter GDP**

This number was revised upward in December from a previously estimated 3.6 percent to 4.1 percent. However, much of this rise was due to inventory buildup that will likely come out of fourth quarter GDP (currently estimated to be about 2.5 percent). But it is still the best quarterly growth in about two years and a growth rate we have seen precious few times in the past 15 years.

- **Rising employment number**

A better-than-expected 203,000 jobs were added to the November payroll. An average of 200,000 jobs were added every month from August through November and the "official" unemployment rate fell from 7.3 percent to 7.0 percent, a five-year low. The number still isn't great, but it has been showing steady improvement. When the good November number was announced, the market rallied strongly, indicating that investors were OK

with a stronger economy even though it meant a greater likelihood of a Fed taper.

- **Auto sales**

Sales of cars and light trucks reached 16.4 million in November, the highest number recorded in six years. The number is consistent with a household purchasing power number that had its highest year-over-year jump in September since early 2006.

While these numbers are encouraging, they still aren't up to 1980s and 1990s standards. For example, more than 200,000 jobs need to be created every month to absorb new workers and put some of the unemployed back to work. There are still way too many long-term unemployed workers. In fact, the country still hasn't created all the jobs lost in the recession, and here we are five years into the recovery.

The Bandwagon Is Getting Crowded

Although this has been a sluggish recovery, things appear to be changing for the better. We may well be turning the corner. The U.S. economy looks better than it has at any point since the financial crisis.

In December, a poll of more than 60 economists conducted by Reuters forecast U.S. GDP growth increasing to 2.5 percent for 2014, reaching 3 percent by year-end. That compared with an estimated growth rate of just 1.7 percent for 2013.

The International Monetary Fund's (IMF) managing director, Christine Lagarde, stated that U.S. GDP growth should be *much* stronger than the organization's previously estimated 2.6 percent growth forecast for 2014 made in October. She didn't give a specific number, but the IMF typically announces revised figures sometime in January (unfortunately coming too late for this writing).

The Fed has also weighed in on the prognosis for the economy with its recent taper. In December, the central bank actually began to pull back, or "taper," its $85 billion per month bond-buying program that has been a big factor in propping up the markets.

The recent taper told us two things. First, that a dovish and squeamish Fed feels confident enough in the strength of the economy to begin pulling back stimulus. This is no small thing. The Fed failed to implement the first taper in September 2013 despite a great opportunity to do so — it had talked it up so much that it was already bought and paid for as far as the stock market was concerned. After that hesitation, many wondered if Fed officials would ever be confident enough to withdraw anything.

The second thing it told us is that the market may be comfortable with the idea of the Fed exiting its stimulus program. The market rallied when the Fed tapered in December and continued strong through the end of the year. This reaction is encouraging. There has been much angst about the Fed's exit (see the July 2013 issue), and so far the market has indicated that it can handle a Fed withdrawal in exchange for a stronger and more self-sustaining economy.

The Peril of High Expectations

The economy's signs of turnaround are very welcome news. For its part, the Fed can't prop things up forever; a stronger economy desperately needs to take hold for the future well-being of the country. I will be rooting hard for continued good economic news.

But as welcome as it is, all this good news makes me nervous.

As I've said, the market has already gone up a lot and now has much to live up to. Markets

▸ About Tom Hutchinson

I've worked in finance my entire career, from the back office of a Wall Street firm to the floor of the New York Mercantile Exchange learning how markets work. Eventually, I became a financial adviser where I met with thousands of investors and managed the portfolios of hundreds over the course of about 15 years. I left my career as a financial adviser, writing for The Motley Fool as well as StreetAuthority LLC, researching companies, industries, and markets. In The High Income Factor, I can bring you the full benefit of my years of investing experience.

anticipate. They generally trade on what is seen ahead for at least the next six months — that means stocks have likely already priced in a stronger economy for the first half of 2014.

If the economy fails to strengthen as anticipated, or some other event threatens to derail the new prosperity, current expectations largely already priced into stocks will not be met. Disappointed investors will run for the exits.

As always, there are risks out there that could derail the economy. For one, don't forget that the Fed will likely continue to taper throughout the year. While the market reacted very favorably to the first taper in December, no one really knows how the stimulus withdrawal will unfold. If interest rates rise gradually and reflect a strengthening economy, things should go well. But if interest rates spike abruptly and quickly, the markets could get spooked.

Then there's China. While the economy seems to have stabilized, the country can be difficult to get an accurate reading on. Should the Chinese economy suffer an abrupt contraction, it could deflate the global economy and U.S. stocks.

And, of course, the biggest risk is usually something we don't see coming.

Even if the economy continues to forge ahead as anticipated, it will only serve to justify current prices. Stocks will only move higher on the basis of anticipated economic strength in the back half of 2014. In other words, the overall market right now is basically a bet that by this summer the economy will not only have been strong, but will stay strong for the rest of the year.

There needs to be a realization of some awfully good news to drive the overall market higher from here. It's a high bar that may or may not be met. Yet, even if the high expectations are realized, there is a good chance the market will experience some fits and starts along the way. We need to take steps to manage the increased risk presented by the new era of high expectations.

There are two good ways to lower such risk.

1. Buy on weakness: We can greatly increase our odds of success by reserving purchases in the overall market for periods when the market sells off. In other words, by targeting certain purchases at below market prices and taking advantage of the volatility, we can counter the risk of high expectations.

"Stocks will only move higher on the basis of anticipated economic strength in the back half of 2014."

In the High Income Factor Portfolio, we are currently targeting two securities in particular at below current market prices. These are great investments that just happen to be a bit on the expensive side. But if we get a market dip, we can shave some of the lofty expectation premiums and pick up these two gems at prices only available to the patient and prepared.

The first is **Magellan Midstream Partners** (**MMP**). As of this writing, it's over $61; our target price is $49.

Magellan is one of the very best master limited partnerships (MLPs) on the market today. It is involved in the transportation, storage, and distribution of refined petroleum products and crude oil and has the longest refined-product pipeline system in the country (8,800 miles), connected to an amazing 40 percent of U.S. refining capacity.

As an energy midstream company, Magellan isn't involved in exploration or production and doesn't sell oil and gas to end-users. It merely collects a fee in exchange for the services of transportation and storage.

About 85 percent of Magellan's revenue is fee-based and has no exposure to volatile energy prices. Not only are these revenues backed with long-term contracts, but the contracts have automatic annual price increases built in, at the producer price index

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(PPI) plus 2.65 percent.

The company has consistently grown earnings to the tune of about 18 percent per year on average for the past five years. Rising profits have led to rising distributions; the partnership has doubled quarterly distribution since 2005 and has paid an average dividend yield of 4.7 percent over the past five years.

The stock performance has been phenomenal. Here's a look at what MMP has returned on an average annual basis compared to Morningstar's oil and gas midstream group and the S&P 500 for the past several years (as of Dec. 31).

MAGELLAN MIDSTREAM PARTNERS PERFORMANCE

	1 year	3 years	5 years
Magellan (MMP)	51.35%	33.69%	34.05%
Oil and Gas Midstream Group (Morningstar)	25.27%	17.77%	26.33%
S&P 500	32.39%	15.84%	17.00%

Looking forward, MMP should benefit strongly from the huge expansion in American energy production as infrastructure continues to be in high and growing demand. The company currently has $1 billion invested in future projects. Consensus analysts' estimates are for earnings to grow more than 17 percent a year for the next five years.

The only problem is the price. MMP is selling at about 26 times earnings compared to its five-year average of less than 20 times. However, picking the stock up during a market sell-off where it happened to fall to the targeted $49 price would take care of that problem.

The second is **Deere & Company** (**DE**). It's over $90 as of writing, while we are aiming to pick it up at $80.

Deere is the world's number one producer of agricultural and forestry equipment. Its world famous John Deere brand has supplied farmers for 175 years. The company derives about 80 percent of net sales from farm and agriculture equipment (tractors and combines) and has a more than 50 percent share of the North American market.

Deere is in an ideal position to benefit from the world's skyrocketing demand for food. The World Bank is projecting that overall demand for food will increase by 50 percent from current levels by 2030 and double by 2050.

Obviously, the world will have to do a lot of farming to keep up, and demand is likely to rise for Deere's tractors, which are considered the best with the highest resale value. Deere is already the largest international player in the industry, and it's growing at a feverish clip overseas.

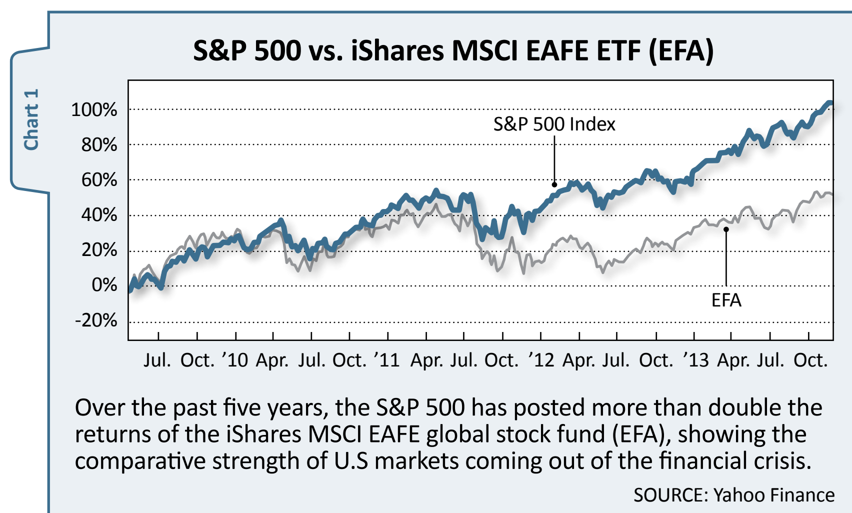
The company has also been aggressively buying back shares. Over the past three years, Deere has decreased the amount of shares outstanding by about 10 percent via buybacks, and it recently announced a new program to purchase another $8 billion worth of stock.

Deere is actually selling at reasonable valuation of 10 times earnings compared to about 18 times for the S&P 500 and its own five-year average of 15.7 times. The only problem is that for income seekers, the dividend yield is on the low side at 2.5 percent at current prices. However, a down market would help with that situation, which is why we're waiting patiently for a dip.

2. Pivot to more reasonable expectations: In recent years, the U.S. market has been king. Chinese growth has come way down from the 10 percent GDP growth of the past two decades while Europe has been mired in recession. The U.S. economy and stock markets have been standouts.

In fact, over the past five years, the S&P 500 Index has posted more than double the returns of the iShares MSCI EAFE global stock fund (EFA). (See Chart 1.)

But how long can such outperformance last? I know I'm not the only one who feels that



Over the past five years, the S&P 500 has posted more than double the returns of the iShares MSCI EAFE global stock fund (EFA), showing the comparative strength of U.S markets coming out of the financial crisis.

SOURCE: Yahoo Finance

U.S. stocks have gotten pricey and is looking for value elsewhere. At the same time, there is strong evidence that economies overseas are beginning to strengthen. Many of these markets are just a little bit behind us and could be at the point in their recovery when their stocks really take off.

For example, many economists, including U.S. Treasury Secretary Jack Lew, believe that the eurozone has pulled out of recession and is headed for significant economic improvement in 2014. Evidence exists to back that up.

Manufacturing output in December was the strongest in the eurozone since May of 2011, before the region's troubles started. Purchasing managers indexes (PMI) in Germany, Spain, Italy, and the U.K. have all shown significant increases in recent months. And industrial production in China has risen in six of the last seven months.

According to economists at Goldman Sachs, Deutsche Bank, and Morgan Stanley, global growth will accelerate to 3.4 percent in 2014. That would be a significant improvement from 2.16 percent in 2011 and 2.82 percent estimated for 2013, and closer to the historical average of about 3.5 percent.

The Organization for Economic Cooperation and Development forecast that growth will pick up over the next year, particularly in the eurozone, China, and the U.K. Barclay's Bank estimates that growth in Britain will accelerate to 2.4 percent from 1.4 percent this year.

Of course, these are just forecasts. There are always risks that can derail progress and sink the markets. But as of now, many global economies appear to be strengthening. And many of the stocks in these markets are overdue to outperform their U.S. counterparts.

But, after such a long period of U.S. market outperformance, many investors aren't considering foreign companies. As you'll see, I think that's their loss and our gain.

A Star Emerges From a Reborn Sector

Financial companies took it on the chin during the financial crisis, to say the least. The industry thrust the world into the worst financial crisis since the Great Depression and many major banks in the West had to get a bailout from the government to stay afloat.

Morningstar's global banking group (banks that conduct business on a global scale) lost more than 80 percent of their total value from peak to trough. And most major banks slashed or eliminated dividends completely.

But that was then, this is now, as they say. While increasing and unpredictable regulations have been a headwind, things have vastly improved over the past few years. Since the crisis, most major banks have improved capital reserves, shored up their balance sheets, and returned to profitability. Despite the disaster of a few years ago, it's still good to be a capitalist in a growth-driven world.

In fact, as the recovery has continued to progress (albeit slowly), banks have become increasingly profitable for the most part, and their stocks have been soaring. Morningstar's global banking group posted returns of 23 percent in 2013, following returns of 37 percent in 2012. Even with that rapid rise, I see room to run going forward.

Banks are particularly well suited for the stronger growth/rising interest rate environment that appears to be unfolding. While today's global banks have a plethora of financial operations, the core banking formula is still making loans. Banks make money by borrowing money at cheap rates and then lending it out at higher rates, thus making money on the spread.

As interest rates rise, so does the spread and profitability, especially as central banks are likely to keep cheap money available for banks to borrow in the foreseeable future. Also, as economic growth strengthens, so does the demand for loans. So, banks appear poised to make more loans at greater profit going forward.

While big banks in the United States have been on fire, many foreign banks, particularly in Europe, have not. But things may be changing.

London-based **HSBC Holdings plc** (**HSBC**) was one of the first financial institutions designed specifically to profit from global commerce. For about 150 years, HSBC has been a crucial financier of East/West trade.

Established in 1865 in order to facilitate trade between China and Europe, HSBC has grown into the second-largest bank in the world (by total assets) and the number one global trade-finance

bank in the world, with about 6,600 offices in more than 80 countries.

The bank has a massive, well-established footprint in the fast-growing Asian economies, where it derives about three quarters of its profits. HSBC also has a strong presence in its home country, as well as the United States, and has growing exposure in Latin American markets. The business model provides a great blend of Western stability and Eastern growth.

The bank's expansive global span makes it a play on worldwide trade and the global economy. HSBC should be a direct beneficiary of increased global economic growth and trade.

However, recent history has not been particularly kind to the banking giant. The stock has been stuck in the mud for a while now. The share price has increased less than 5 percent over the past five years. That compares with about a 50 percent increase in the U.K. bellwether FTSE 100 index, and about a 100 percent move up for the S&P 500 index over the same period.

But the divergent performance has been even more pronounced over the past year. The stock eked out just a 10 percent total return in 2013 (including dividends) compared to about 30 percent for the S&P 500. And 2013 was a banner year for U.S. banks. This table shows the returns for the largest U.S. banks.

Largest U.S. Banks	2013 Returns
Wells Fargo (WFC)	32%
Bank of America (BAC)	36%
Citigroup (C)	34%
Goldman Sachs (GM)	34%
JPMorgan (JPM)	33%

HSBC Holdings' underperformance has made it cheaper than its U.S. counterparts. The bank currently sells at just 12 times earnings, compared to 14.4 times for U.S. banks and about 18 times for the S&P 500 Index.

HSBC got clobbered along with the other major Western banks during the financial crisis. But its geographical diversification enabled the bank to weather the storm significantly better than most. In fact, HSBC was one of the only major banks not to take government money in the aftermath of the crisis.

Stocks of major Western banks continued to wallow in oblivion in the first few years after the recession. But things picked up for the sector in 2012 as banks shored up their reserves and returned to profitability while the economy continued to recover.

But last year, HSBC's geographical diversity held it back. The U.S. economy proved to be stronger and more resilient than most other large developed economies, and the accommodative Fed continued to fuel the rise in stock prices with its quantitative easing. This proved to be a great backdrop for U.S.-based banks. But HSBC stock was hampered by the sluggish global economy.

The strong U.S. stock market, combined with the continued recession in Europe and the slowdown in China, caused investor enthusiasm to focus on the United States. Although, the stock didn't perform particularly well in 2013, HSBC posted a strong year operationally.

Poised to Prosper

In addition to the financial crisis and the sluggish global economy, HSBC has also been restrained by missteps it made in the go-go days of the past decade.

The bank made some bad acquisitions away

PICK AT A GLANCE

HSBC HOLDINGS PLC (HSBC)

SECURITY TYPE: Common Stock
INDUSTRY: Global banking
PRICE: $55.56 (as of Jan. 7, 2014)
52-WEEK RANGE: $50.38–$58.71
YIELD: 3.60%
PROFILE: HSBC is one of the largest banks in the world, and among big banks is the most levered to the movements of world trade and the global economy.

POSITIVES

- The bank gains stability from its presence in the U.S. and U.K. markets and growth from Asian markets.
- Earnings and the dividend have been on the upswing.
- The stock is cheap and pays a high dividend, and is perfectly positioned to benefit from any pickup in the global economy.

RISKS

- The regulatory environment for large banks in the aftermath of the financial crisis is brutal, particularly in the U.K., and will continue to be a headwind.
- Several Asian economies, where HSBC has huge exposure, will likely react negatively as the U.S. Federal Reserve tapers its stimulus.

from its core business that proved costly.

For example, HSBC acquired American mortgage company Household in 2002. Needless to say, the acquisition proved disastrous in the throes of the financial crisis and Household was shuttered in 2009.

However, the bank has gotten serious about correcting past mistakes and began a significant reorganization in 2011. Management has been selling off noncore businesses and has cut costs significantly, to the tune of $4.5 billion per year for the past three years.

Chart 2

HSBC Holdings Stock Price, 2009–2013

UK-based HSBC has recovered since the financial crisis, but it still lags its true value, in my opinion. We can enter now and collect dividend income while waiting to capture the capital appreciation that should come with continued global growth.

SOURCE: Yahoo Finance

Now, HSBC has one of the strongest balance sheets among major banks and among the best capital ratios (measures of risk assets to overall assets). In addition, the bank has achieved a goal of growing revenue faster than costs (currently 9 percent faster).

Despite the lame stock performance, earnings per share (EPS) have been stellar, growing 22 percent year over year in the first nine months of 2013. Going forward, HSBC management sees China stabilizing and the U.K. economy outperforming the eurozone in 2014.

Analysts are forecasting continued double-digit earnings growth in 2014 and an average of over 13 percent per year for the next five years.

A Look at the Dividend

My favorite thing about HSBC is that it pays a huge dividend for a major bank these days. The stock pays quarterly dividends that are typically the same for the first three quarters, while the fourth-quarter dividend varies according to earnings (declared when fourth-quarter earnings are reported in February).

The last four dividends totaled $2.40 per share; the current yield is 3.60 percent.

Dividends have consistently grown every year since 2008 and are expected to rise again in 2014, perhaps strongly if the global economy performs well.

Although HSBC is a foreign company, there is no withholding tax in the U.K. Also important to note for potential investors is that the payout is subject to the 15 percent minimum tax. There is admittedly a currency risk with HSBC, as most revenues are generated in foreign countries and converted to U.S. dollars for ADR dividends.

▸ **Conclusion: HSBC Holdings plc (HSBC) is a blue chip, high-dividend-paying stock that provides an excellent way to play the resurgent global economy. Recent underperformance in HSBC shares, along with the possibility of better performance of non-U.S. stocks in 2014, provides a stellar entry point at or under $60 per share for our Wealth Builder Portfolio.**

Best Buys of the Month

I began "best buys" a few months ago as a way to point out what I think are especially good values among all the holdings in our portfolio as we go to press. The basis by which each security is chosen each month is not a specific formula, and the picks are not necessarily those with the cheapest price compared to their recommended "buy in" level.

What they are, however, is a good guideline, especially for those new to the High Income Factor newsletter. They're the answer to the question, "If I were just starting to invest in the High Income Factor Portfolio, which securities would I buy first?"

FEBRUARY BEST BUYS

Security	Price*	52-Week Range	Yield
Health Care REIT (HCN)	$54.26	$52.43–$80.07	5.6%
Kinder Morgan Energy Partners (KMP)	$80.55	$77.13–$92.99	6.7%
Fly Leasing (FLY)	$16.05	$12.62–$17.37	5.5%

* As of Jan. 7, 2014

Health Care REIT (HCN): This operator of senior living and medical properties is a solid

dividend-paying stock that has absolutely been walloped lately. It was added to the Wealth Builder Portfolio at $60 in August and the price has since fallen to $54.26. For 2013, while the S&P 500 soared 30 percent, HCN returned minus 7.6 percent. It is also down 32 percent from its 52-week high in May 2013.

The performance is on par with the healthcare REIT sector as a whole. Basically, REITs, as desirable income-paying securities in an income-starved market, became too overpriced. When the Fed announced its intention to taper in May, investors annihilated these stocks.

The fear has been that REITs will underperform in the rising interest rate environment that will ensue as the Fed continues to taper. But I think the interest rate risk for REITs has been overestimated.

Real estate has qualities that can offset the cost of rising interest rates. Interest rates generally rise at a time when the economy is strong. A stronger economy typically generates increased demand for real estate and consequently higher prices. Better economic growth also tends to bring up occupancy rates for commercial and retail real estate properties, and rental rates tend to rise.

> "HCN is perfectly positioned to benefit from perhaps the most pronounced megatrend of all going forward."

There is also empirical evidence for the resiliency of REITs in a rising rate environment. Since 1994, interest rates have risen in 16 different periods. REIT prices actually rose during 12 of those periods.

The recent market overreaction has created a great entry opportunity for long-term investors seeking reliable cash flow. HCN is in a particularly promising segment. It is perfectly positioned to benefit from perhaps the most pronounced megatrend of all going forward, the aging of the population.

Health Care REIT has a well-diversified portfolio of health properties for the elderly including assisted living facilities, skilled nursing properties, independent living communities, hospitals and medical office buildings. Most rent contracts have inflation adjustments built in and are also not overly vulnerable to changing healthcare laws, as 83 percent of the properties are private pay (not Medicare).

The REIT has undergone a rapid expansion to take advantage of the opportunity. In 2012, HCN acquired $5 billion in additional properties; $1.5 billion worth of acquisitions were made in the second quarter of 2013. The acquisitions are really bearing fruit, as revenues soared 55 percent in the second quarter and 72 percent in the third quarter.

The company has a reliable dividend that should be able to endure a rising rate environment. HCN's leadership reaffirmed its full year 2013 earnings growth outlook of 5 percent to 8 percent per share. With a 5.6 percent dividend yield, and its predictable revenue stream, HCN still looks promising.

Kinder Morgan Energy Partners (KMP): Wealth Builder Portfolio holding Kinder Morgan Partners (KMP) has performed poorly of late, but is poised to deliver good returns in 2014 and beyond. The stock was added to the Wealth Builder Portfolio on May 22, 2013, at $88.50, and has since given us a total return of negative 7.46 percent in about eight months, including dividends.

As the largest individual player in U.S. energy infrastructure (piping and storage), KMP should benefit from the energy boom currently underway in the United States.

But the stock has been stagnant. It delivered an anemic 7.7 percent for 2013 compared to 25 percent for the oil and gas midstream sector, and over 30 percent for the S&P 500 as a whole. And most of the 7.7 percent return was from the distribution; the stock price was nearly flat for the year.

But long-term returns have exceeded those of the market and the sector, and this abhorrent performance has created a great opportunity in my opinion. The stock currently yields 6.7 percent, compared to 4.3 percent for the sector, and has been among the most stable revenue generators and distribution payers on the market. There are also huge catalysts for future growth associated with increased U.S. energy production.

In the past couple of months, the partnership made moves that should boost returns in the coming year and beyond. On December 23, KMP announced that it will be purchasing two tanker companies for $962 million from private equity firm Blackstone Group, specifically American Petroleum Tankers and State Class Tankers.

At first glance, this is a foray into a new industry, shipping. But at closer inspection, the ships are very much a part of the same energy delivery business that is currently in very short supply and high demand. In addition, these ships have something that will make them extremely popular among customers: They are Jones Act qualified.

The Jones Act is a law passed in 1920 to limit foreign maritime competition for internal U.S. shipping. Basically, only U.S. ships can deliver from port to port in this country, and there is a very limited supply of them. There is currently insufficient delivery infrastructure in the country for the growing energy production, and these ships should generate very stable and growing revenue. Water transportation is particularly desirable because it's relatively cheap.

"Offering good answers to companies in a brutally competitive industry is a strong business model."

The deal includes nine ships, five of which are already operating under long-term contracts and four that are under construction and scheduled to be delivered in 2015 and 2016. The five existing ships will be immediately accretive to earnings by an estimated EBITDA of $55 million per year right away, with an impact of $140 million per year when the new ships are operational in 2016.

In addition, KMP also announced a joint venture with **Targa Resource Partners (NGLS)** to construct two facilities to process natural gas liquids (NGLs) from the shale regions of Texas. NGLs should grow significantly in the years ahead, as they represent a way to export cheaper U.S. natural gas to foreign countries where it can fetch a much higher price.

While these recent announcements aren't necessarily "game changers" in and of themselves, they add to the existing narrative of a reasonably valued MLP that should be able to grow revenues and distributions in the future. A magnificent income-paying security with a sizable 6.7 percent yield, a reasonable price, and excellent catalysts for earnings growth is quite rare in today's market. The current price is a nice entry point for KMP, as is anything under my recommended level of $88.50.

Fly Leasing (FLY): FLY entered the High Income Portfolio on November 27, 2012 at $11.97. Including dividends, it has given us a total return of 40.53 percent in about 14 months.

This lessor of jet aircraft still looks good even after having generated superior returns. The company recently announced solid third-quarter earnings per share, nearly doubled from the year ago quarter, and raised the quarterly dividend 14 percent from $0.22 per share to $0.25.

Not only does the dividend hike increase the yield to 6.2 percent at this price, but it also reflects management's strong confidence in future performance.

Airplanes are in high demand these days and leasing is an attractive option. Cash-strapped airlines find it much easier to lease a plane than buy one. The cost is far less and the airline doesn't have to manage a complicated and depreciating asset. Offering good answers to companies in a brutally competitive industry is a strong business model.

It's the industry fundamentals that make FLY a particularly timely pick. These are good times for airlines. Global air traffic is near all-time highs and expected to continue to grow strongly in the years ahead. And about one-third of the global airline fleet is leased. That rising demand results in rising lease rates.

FLY has aggressively expanded its fleet over the past year and has the finances available (because of a $170 million July share offering) to continue expanding in 2014. But, as promising as things look, the stock still sells at a very cheap 30 percent discount to its book value. A continuing global recovery should propel this stock higher. ■

The High Income Factor Portfolio

THE HIGH INCOME PORTFOLIO

Recommendation	Ticker	Entry Date	Entry Price	Recent Price	Buy at or Under	Current Yield	Effective Yield	Dividend Pay Date	Total Return
Navios Maritime Partners	NMM	01-Mar-12	$16.37	$18.58	$16.50	9.53%	10.81%	2/13/14	36.31%
SeaDrill	SDRL	01-Feb-12	$35.24	$40.19	$36.00	9.46%	10.78%	3/20/14	36.19%
Terra Nitrogen	TNH	01-Apr-12	$249.75	$148.86	$255.00	9.64%	5.75%	3/3/14	-23.43%
Legacy Reserves LP	LGCY	01-Sep-12	$27.78	$28.33	$29.00	8.26%	8.42%	2/14/14	18.85%
FLY Leasing Limited	FLY	27-Nov-12	$11.97	$16.05	$16.00	5.48%	7.35%	2/20/14	40.53%
Teekay LNG Partners LP	TGP	20-Dec-12	$38.30	$41.94	$39.00	6.44%	7.05%	2/12/14	16.72%
Prospect Capital	PSEC	26-Feb-13	$11.06	$11.26	$11.50	11.81%	12.03%	1/21/14	12.56%
Main Street Capital	MAIN	21-Aug-13	$29.21	$34.04	$32.00	5.82%	6.78%	1/15/14	20.70%

THE WEALTH BUILDER PORTFOLIO

Recommendation	Ticker	Entry Date	Entry Price	Recent Price	Buy at or Under	Current Yield	Effective Yield	Dividend Pay Date	Total Return
PepsiCo	PEP	01-Apr-12	$66.74	$83.48	$72.00	2.72%	3.40%	1/30/14	31.61%
Eli Lilly	LLY	01-Apr-12	$40.48	$51.19	$52.00	3.83%	4.84%	3/10/14	35.66%
Williams Partners	WPZ	01-May-12	$57.30	$49.93	$58.00	7.03%	6.13%	2/12/14	6.07%
Vodaphone	VOD	27-Sep-12	$28.72	$38.81	$34.00	4.15%	5.61%	2/7/14	40.64%
Intel	INTC	27-Nov-12	$19.98	$25.58	$23.00	3.52%	4.50%	3/3/14	32.26%
Philip Morris	PM	04-Feb-13	$87.00	$84.68	$87.00	4.44%	4.32%	1/14/14	1.40%
Riocan REIT	REI-UN.TO	20-Mar-13	$26.97	$27.19	$29.00	5.16%	5.21%	1/10/14	0.91%
General Mills	GIS	19-Apr-13	$49.94	$49.85	$50.00	3.05%	3.04%	3/3/14	1.38%
Kinder Morgan Energy Partners	KMP	22-May-13	$88.50	$80.55	$88.50	6.70%	6.10%	2/14/14	-7.46%
Brookfield Infrastructure Partners	BIP	03-Jun-13	$36.00	$38.71	$40.00	4.44%	4.78%	1/28/14	8.83%
Health Care REIT	HCN	15-Aug-13	$60.00	$54.26	$60.00	5.64%	5.10%	2/20/14	-8.41%
BP plc	BP	22-Nov-13	$47.65	$48.55	$50.00	4.70%	4.78%	3/20/14	1.89%
Realty Income	O	18-Dec-14	$39.14	$38.12	$40.00	5.73%	5.58%	1/15/14	-2.61%
Magellan Midstream Partners#	MMP	—	—	$61.31	$49.00	3.60%	—	—	—
Deere & Company#	DE	—	—	$90.31	$80.00	2.50%	—	—	—
BUY HSBC Holdings plc#	HSBC	—	—	$55.56	$60.00	3.60%	—	—	—

#Denotes recommendation not yet purchased.

INCOME STRATEGIES PORTFOLIO

Recommendation	Ticker	Entry Date	Entry Price	Recent Price	Buy at or Under	Current Yield	Effective Yield	Dividend Pay Date	Total Return
Blackrock Enhanced Capital Fund	CII	01-Jan-12	$12.50	$13.74	$13.00	8.73%	9.60%	1/30/14	29.96%
Barclay's 7.75 Preferred	BCS-PC	27-Sep-12	$25.52	$25.36	Hold	8.04%	7.99%	1/16/14	9.39%
PowerShares Preferred	PGX	24-Oct-12	$14.84	$13.71	Hold	6.48%	5.98%	4/3/14	-2.05%
Osterweis Strategic Income	OSTIX	25-Sep-13	$11.80	$11.86	$12.00	5.04%	5.07%	1/17/14	1.43%
PowerShares Senior Loan Portfolio	BKLN	25-Sep-13	$24.77	$24.92	$25.00	4.04%	4.07%	2/3/14	1.61%
WisdomTree Emerging Mkts Eq Income	DEM	23-Oct-13	$53.87	$48.85	$56.00	4.28%	3.88%	1/27/14	-8.75%

Notes on all portfolios: In order to receive the dividend payment, you will need to own the stock several weeks before the pay date. The "Total Return" column includes all reinvested dividends at concurrent recommended buy prices. Returns calculated based on a purchase of $1,000 of the security on the listed entry date and price. The "Effective Yield" column reflects the yield investors receive assuming they bought at the entry price and followed all subsequent recommendations. All data as of close January 7, 2014.

SOLD POSITIONS

Recommendation	Ticker	Portfolio	Entry Date	Entry Price	Exit Date	Sell Price	Total Return
American Capital Agency Corp.	AGNC	High Income	16-Dec-11	$27.95	05-Jul-12	$33.94	29.47%
Westpac Banking Corp	WBK	High Income	01-Jun-12	$97.71	01-Feb-13	$147.98	56.56%
CPFL Energia	CPL	High Income	01-Jun-12	$23.60	01-Feb-13	$20.67	-10.47%
Abdn Asia-Pacific Income Fund	FAX	Income Strat	01-Aug-12	$7.83	05-Jun-13	$6.55	-13.55%
Pimco Income Opportunity Fund	PKO	Income Strat	01-Dec-11	$25.64	03-Jul-13	$28.00	23.09%
PowerShares Insured National Muni Bond	PZA	Income Strat	01-Aug-12	$25.72	10-Oct-13	$22.99	-7.19%

The
High Income Factor

The High Income Factor is a monthly publication of Newsmax Media, Inc., and Newsmax.com. It is published at a charge of $109 for print delivery ($97.95 for digital/online version) per year through Newsmax.com and Moneynews.com.

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Closing Thoughts

It is well known that bad news and panic can create opportunity for investors. You can buy cheap while others are selling irrationally, and profit over time.

But it is less understood that the reverse is also true. That is, good news and high expectations can create peril.

It looks like the economy is finally turning the corner. That is fantastic news. But the optimism has lifted stock prices a lot already, and high expectations have given them a great deal to live up to going forward. The strong positive outlook has increased the odds of disappointment and falling stock prices in the United States.

But that's OK as long as we adjust to the higher level of risk. In U.S. markets, we can prepare to take advantage of volatility and pick up great securities at cheaper prices. We can also target undervalued overseas markets.

HSBC Holdings plc (**HSBC**) is a huge international bank that is perfectly situated to benefit from a likely increase in global economic activity. Its stock performance has lagged that of its U.S. banking counterparts, but its internal fundamental measures have not.

Economic growth is good for stocks. We just need to pivot to those stocks that are more likely to benefit in the near term.

Actions to Take Now

Action No. 1: Watch for a chance to add **HSBC Holdings plc** (**HSBC**) to The Wealth Builder Portfolio at or under $60 per share.

Action No. 2: Consider putting any new money you're looking to invest in these three High Income Factor picks that are especially good deals right now: **Health Care REIT** (**HCN**), **Kinder Morgan Energy Partners** (**KMP**) and **Fly Leasing** (**FLY**).

Sincerely,

Tom Hutchinson

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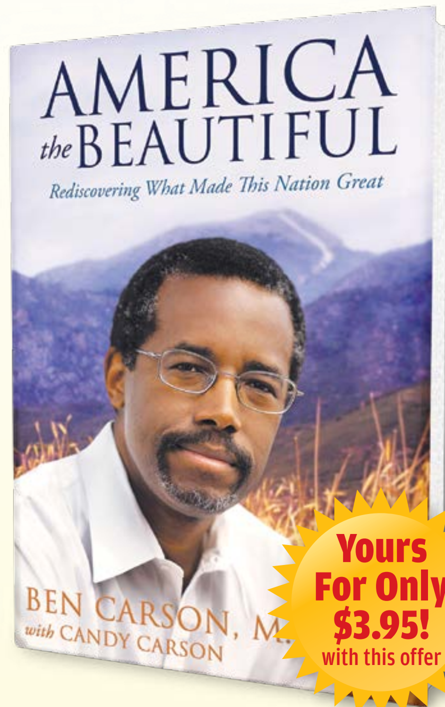

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