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The

High Income Factor

Unlocking Powerful Strategies to Achieve Superior Returns

Tom Hutchinson, Editor

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Spectacular Oil Collapse Creates a Rare Income Opportunity

I talk to investors all the time, whether on the phone with friends, at get-togethers with our neighbors, the local deli where I go get my lunch. I also had the chance to talk to a few folks this past December, when I was in New York City at the Newsmax Economic Forum.

The common thread lately? People all believe the stock market is expensive.

And with a price-to-earnings ratio hovering around 20 for the S&P 500, they're right. But they'll also concede that, despite the premium prices, stocks are still probably the best place to be.

Time after time, I've heard the same thing. "I'm just reluctant to put new money in the market right now."

It's an understandable attitude when you consider how far we've come. The S&P 500 has tripled since the lows in 2009. It's naturally difficult to invest with confidence when stock prices in the aggregate are so much higher than they were just a few years ago. Your natural reaction is to figure the upward surge has to stop at some point soon and start to slide backward.

Too bad we don't have a time machine, right?

Imagine if we were able to go back to late 2008 and early 2009 and pluck stocks at fire-sale prices. We could buy **Apple** (**AAPL**) at less than a post-split equivalent of $20 per share instead of the $110 it is now. **Nike** (**NKE**), which is now $67 per share, sold for a low of about $5.

Even relatively conservative income stocks have delivered stunning returns. You could have bought "blue chip" real estate investment trust (REIT) and portfolio position **Realty Income** (**O**) at under $20 per share in the bear market with a yield of over 9 percent. Now the stock is $50 with a yield of 4.8 percent.

And petroleum infrastructure master limited partnership (MLP) **Magellan Midstream Partners** (**MMP**) is $85 with a yield of 3.4 percent. In late 2008, MMP sold for $15 per share and yielded 9.5 percent.

> "Even when the fear after 2008 waned, the prevailing attitude among investors was negative toward stocks."

Obviously, investing would be easy with the benefit of hindsight. But in the depths of the financial crisis there were scant few brave souls willing to put money in a market that was crashing through 30 percent, then 40 percent, and even 50 percent with no sign of stopping.

It seemed like financial suicide to step up and put your money in the middle of a financial tsunami.

Of course, investors had many years after the financial crisis, when the recovery was beginning to bloom, to invest at what are today extremely advantageous prices. But even when fear waned, the prevailing attitude among investors, and pundits for that matter, was negative toward stocks.

You could always find a reason, some quite compelling, not to invest. *The Fed's money printing*

scheme is going to blow up. Europe could thrust us into the next crisis. The government might default on debt payments. The recovery is fake — just a continued recession propped up by the Fed. And so on. Most investors stayed away.

The truth is, investing is hard. We are naturally wired not to put our money at risk.

For most of us, there is always a better argument to be made for steering clear. If the economy and the market are in good shape, stock prices are too high. If prices are cheap, it's because of fundamental flaws in the economy that will likely get worse.

Yet, over the long haul, people who have put aside those common fears and invested in the stock market have won big.

A Financial Crisis-Like Opportunity

While the overall market may be near all-time highs, one segment has experienced the most severe bear market since the financial crisis: commodities.

Commodity prices have crashed, and many oil, gas, metals, and basic materials companies are selling at prices 40 percent or even 50 percent or more below where they were selling just this past summer.

Whenever an industry is battered to this degree, there are excesses. Things fall further than they deserve based on fundamental metrics. Because of the unpredictable nature of human emotion that drives buying and selling decisions, the market tends to overdo moves in the short run.

So, for those with a long view, the commodity sector turmoil has created some of the best opportunities that have existed since the depths of 2008 and 2009.

In this issue, I will tell you why the largest and most diversified natural resource company in the world is particularly compelling. Even in the current challenging environment, this company should continue to generate strong cash flows and profits. The company sells at the cheapest price in more than five years and yields a stellar 5.7 percent.

But cheap prices always come with great fear. We can't see several years ahead. It tests our comfort level to buy into a bear market. But such discomfort can give rise to potentially huge profits.

Here's the situation.

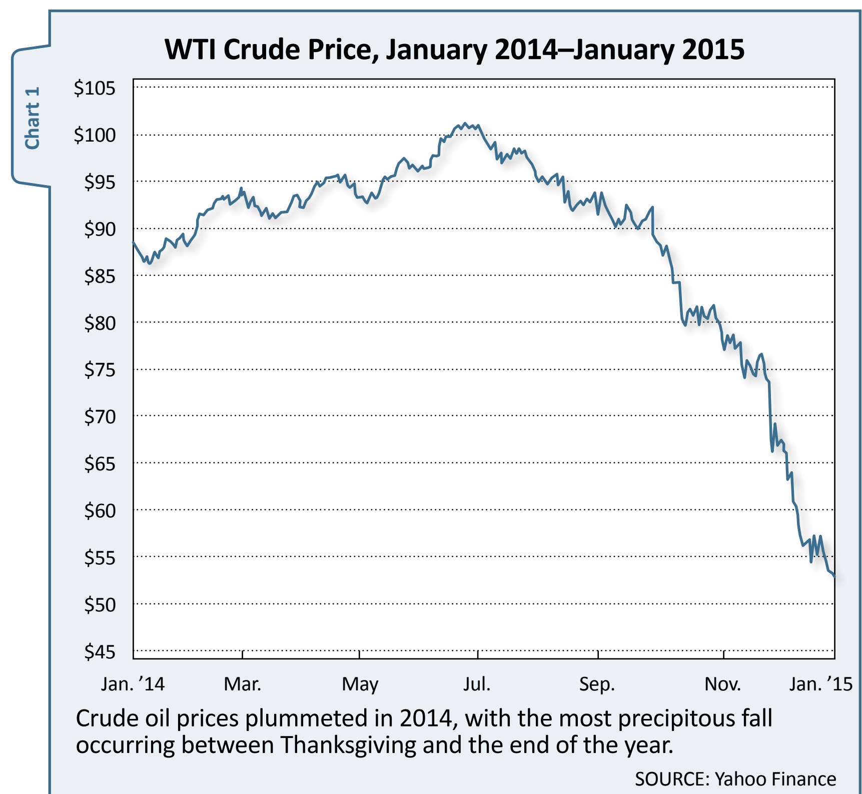
The Great 2014 Commodity Crash

As I am sure you have noticed, oil prices have been plummeting of late. Although price volatility is common for any commodity, this is different. The price drop has moved well beyond the scale of normal volatility into the realm of a major event.

Between the summer and the end of the year, the price for WTI (West Texas Intermediate) crude oil came down roughly 50 percent. Much of the decline happened even more quickly. Prices dropped about 30 percent just between Thanksgiving and the end of the year. That's a heck of a fall. (See Chart 1.)

Crude has not had a rapid descent anywhere near this magnitude since the financial crisis. The decline has been so precipitous that it moved beyond seasonal or even secular volatility into the realm of an all-out global event.

Indeed, the oil price crash was one of the biggest financial stories of 2014. But while the

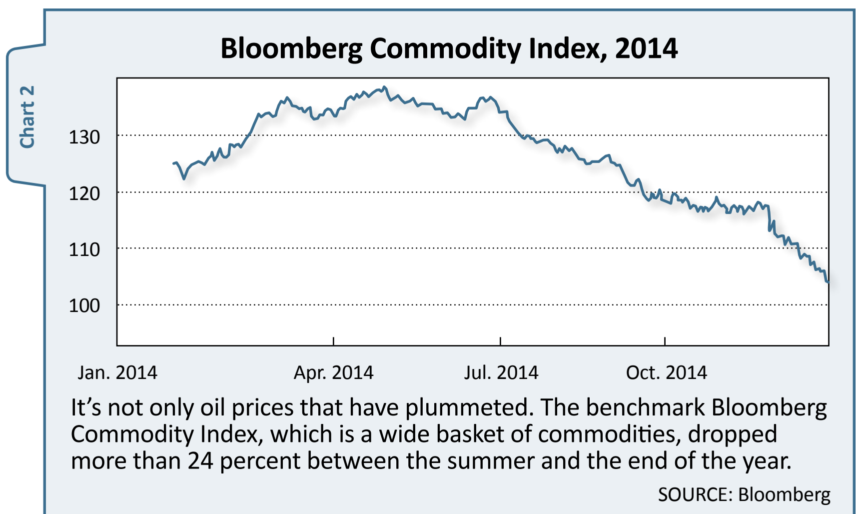


Crude oil prices plummeted in 2014, with the most precipitous fall occurring between Thanksgiving and the end of the year.

SOURCE: Yahoo Finance

decline in oil has been the most dramatic, crashing prices are far more widespread than just oil.

Commodity prices across the board have been in near free fall. The Bloomberg Commodity Index, a highly regarded benchmark of the overall commodities market, fell more than 24 percent between the summer and the end of the year. (See Chart 2.)



It's not only oil prices that have plummeted. The benchmark Bloomberg Commodity Index, which is a wide basket of commodities, dropped more than 24 percent between the summer and the end of the year.

SOURCE: Bloomberg

It's worth noting that just about every other commodity index out there has fallen more than the Bloomberg one, more than 30 percent in most cases. I use the Bloomberg index as a barometer because most other indexes are too heavily weighted in crude oil and reflect the price crash in that commodity. But Bloomberg is more reflective of the prices of hard assets in general.

Crude oil and oil-related products like gasoline and diesel account for only 20 percent of the index's weighting. It provides broad exposure to a wide basket of commodities, including stuff like sugar, zinc, cotton, and cattle. (See the selection of weightings in the box below.)

Bloomberg Index Sector Weights	
Energy	27.15%
Agriculture	32.00%
Industrial Metals	18.44%
Precious Metals	15.79%
Livestock	6.62%

Energy, metals, bullion, and agricultural commodities have all hit multiyear lows. Aside from oil, the declines have been most intense in industrial metals. The **SPDR S&P Metals and Mining ETF** (**XME**), which tracks a host of commodities like steel, coal, aluminum, and gold, fell about 30 percent between the end of the summer and the end of the year. In particular, iron ore (which is the main input for steel) was down over 46 percent for 2014.

What's going on?

The Changing Dynamic

The global repricing of commodities is happening for three primary reasons.

1. End of a super cycle: As China and other emerging-market economies burst onto the world stage last decade, global industrial production exploded. Voracious new demand created skyrocketing prices for global commodities suddenly in limited supply.

The Thomson Reuters CoreCommodity CRB Index illustrates the effect. This index tracks 19 different commodities (including oil, gold, sugar, cotton, corn, and copper) and has existed for more than 50 years. In 1998 the index was under 120. By 2008 the value had soared to 474. The same index finished 2014 at about 230.

To keep up with the growing demand, countries invested massively in mining and drilling, and this new supply is now available on the market. Consequently, supply and demand are now close to equilibrium.

2. Slow global growth: As I've often mentioned in previous newsletter issues and

▸ 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.

updates, in contrast to the U.S., the global economy is in a funk right now.

The eurozone is teetering on the brink of recession. Japan has just had two consecutive quarters of significant contraction. Growth in China has significantly slowed from the double-digit gross domestic product growth it posted for about two decades to an estimated 7-7.5 percent.

Not only is China slowing but the nature of its growth is changing. The country is experiencing a real estate bust of sorts and new investment is shifting away from the building boom of years past.

The shift has a significant effect on the commodity markets because China has come to consume more than 40 percent of the world's metal supply.

This past October, the International Monetary Fund (IMF) lowered its global growth forecast for 2014 and 2015. The organization now expects world growth to be 3.3 percent in 2014, 0.1 percent lower than its earlier forecast. For 2015, it reduced its expectation from 4 percent to 3.8 percent, citing slow growth in Europe and emerging markets like Russia and Brazil for the downgrade.

This slower growth hits the demand side of the equation for commodities. Weaker demand puts downward pressure on prices.

The U.S. Dollar Index (top) is heading up, while commodity prices — represented in the bottom chart by the PowerShares DB Commodity Tracking ETF (DBC) — are dropping. That's no accident — a soaring dollar puts pressure on commodity prices. This is compounded by slowing global economic growth.

SOURCE: TradingEconomics.com, Yahoo Finance

3. Dollar dominance: The worth of the U.S. dollar is most commonly measured by the dollar index, which assesses the value of the dollar versus a basket of well-established foreign currencies. This index is experiencing a significant rise of late.

The dollar value has soared from 80 this past July to over 91 at the end of 2014. That kind of spike in such a short time is unusual. The dollar recently hit a nine-year high against the euro and its highest overall level since 2005.

Two primary reasons exist for the rise of the greenback: better economic performance and divergent central bank policies. While the global economy is sputtering, the U.S. economy is cooking. Since the middle of 2013 (minus the first quarter 2014 weather aberration), the U.S. economy has averaged over 4 percent GDP growth. The most recently reported third quarter came in at a stunning 5 percent.

The relative strength in the U.S. versus the rest of the world, particularly Europe and Japan, is elevating the dollar. But the central banks are also playing a role.

The Bank of Japan (BOJ) recently instituted a massive easing program (buying bonds and holding interest rates low) and the European Central Bank (ECB) is expected to follow suit in the near future. This aggressive central bank activity typically has the effect of weakening the value of a currency.

Meanwhile the U.S. Federal Reserve Bank is going the other way and withdrawing its stimulus. Last year the Fed ended its $85 billion per month bond-buying program and this year is expected to begin *raising* interest rates. The divergent central bank policy is also powering the dollar higher.

A rising U.S. dollar generally means lower commodity prices. Commodities are mostly priced in U.S. dollars (as the world's reserve currency). When the dollar is worth more, hard assets (other things being equal) diminish in price in dollar terms.

Charts 3 and 4 provide a good illustration. The top chart is the U.S. Dollar Index and the bottom chart is the **PowerShares DB Commodity Tracking ETF** (**DBC**), one of the largest funds on the market that tracks a broad basket of commodity prices. As you can see, starting in about July of last year, the dollar has steadily risen and DBC has steadily fallen.

A stronger dollar in and of itself puts downward pressure on commodity prices. But also some of the same dynamics driving the dollar higher, such as the slowing global economy, are putting downward pressure on commodity prices.

Now What?

Commodity prices have already been hit rather dramatically. Current prices are reflecting the lopsided growth story and a mighty dollar. All the data I've shared here simply reflect what has already happened.

The key question for us to answer is, "Where do we go from here?" Will prices go lower, stay the same, or move higher?

Let's look at each case.

Prices go lower from here. Sentiment is awfully gloomy and prices of commodities and stocks of commodity companies already reflect a dreadful situation. What are the chances that things get even worse? Make no mistake about it. Things can always get worse.

As we noted earlier, the IMF revised its global GDP growth projections downward in October. But the IMF also states that there are increasing downside risks to the current forecast.

One of the risks is Europe. There is an election coming up in Greece as of this writing where a new government could be elected that could potentially take Greece out of the eurozone. There are also upcoming elections in other countries like Portugal. More upheaval in the eurozone could easily thrust the continent back into recession and potentially ignite a debt crisis.

Then there's China. The country is still a closed society and no one on the outside truly knows what is really going on there. It is always possible that the country will reveal economic numbers far below what is currently expected. Slower growth in China will have a significant impact on emerging market economies and global growth as well as commodity prices.

Geopolitical risk is also a problem. Russia is still in Ukraine, and Western nations are discussing increasing sanctions. The Russian economy is already reeling from the earlier round of sanctions and even more from falling oil prices. An increasingly desperate Russia could be more dangerous. Increased tensions would likely put even more pressure on the already fragile European economies.

There is also instability in the Middle East with the civil war in Syria and ISIS still on the move. Any kind of serious international conflagration would further weaken the global economy and likely send commodity prices plunging further.

Prices go higher from here. It's a fool's errand to try to pick a bottom for commodity prices. It is impossible to know the state of things a month from now. However, the market usually overdoes it on the downside in sell-offs like this and there is a good possibility that prices are higher in six months or a year from now.

Lower commodity prices are often self-correcting. Take oil for example. As the price has fallen 50 percent, certain drilling sites will become

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unprofitable and shut down, reducing production and supply.

At the same time, cheaper prices tend to increase demand. Increasing demand coupled with decreasing supply will put upward pressure on prices over time.

It's the same dynamic with other commodities. Lower prices act as an economic stimulus, similar to tax cuts and low interest rates. The cost to consumers and businesses alike goes down. With more money in their pockets and cheaper prices for goods, consumer demand tends to increase. Many businesses also become more profitable.

Other things being equal, lower prices for goods create a dynamic that makes prices go back up.

It could well be that a new supply/demand dynamic results in commodity prices trading in a lower range than before. But that still doesn't change the likelihood that prices will trade higher than they do now in the not-too-distant future.

A Blue Chip Company in the Doghouse

Perhaps the most fundamental and timeless piece of investment advice is to buy good companies when they are cheap. It seems simple. And it is. The practice is particularly well suited for income investors, as you can get a higher yield at lower share prices.

Individual sectors of the market go in and out of favor all the time. One year utility stocks may be the best (or perhaps the worst), and another year the technology sector reigns as king. Consumer stocks could have a bad first half of the year and a great second half. This is business as usual in the market.

Historically, it has been a much more successful practice to buy sectors that have recently been out of favor than to jump into last year's hottest sector. Recently, the worst-performing sectors of the market by far have been those associated with commodity-oriented stocks.

Morningstar's Energy and Basic Materials groups have been the two worst performing sectors for every recent measurable period from three months to five years. The Industrial Metals & Minerals sector returned negative 8.43 percent in 2013 and negative 28.55 percent in 2014. That sector underperformed the S&P 500 by more than 40 percent in each of the last two years.

Of course, it is possible that a sector can continue to underperform for longer. As I mentioned above, if the global economy worsens, commodities could have another leg down. But I believe there is an opportunity in this sector not only because of recent underperformance; there is reason to believe things have gotten overdone.

The culprit, of course, is oil. A perfect storm has led to the 50 percent collapse in oil prices, dragging the price of other commodities down to abnormally lower levels.

Several things have driven oil's epic collapse.

First is the U.S. energy boom. Massive quantities of oil from U.S. shale fields have come on line in recent years, significantly impacting global markets.

At first, the new production had little effect on oil prices because of supply problems elsewhere. U.S. oil replaced Iranian oil disrupted by sanctions and Libyan oil disrupted by war. But production has since returned in those countries.

At the same time, the global economic slowdown hurt demand, just as more supply hit the market.

Then there are the Saudis. For decades, Saudi Arabia had moderated oil price swings by decreasing production when prices fell too low. But in the past, other OPEC countries cheated and produced more, which meant the Saudis ended up losing market share. They're tired of that and won't cut production this time.

When the Saudis announced their intention to keep on pumping away, oil prices really tanked. The rising dollar has been icing on the cake.

Panic selling is contagious. The very public collapse in oil prices has acted as a vortex sucking other commodities down with it.

At some point in the next few weeks or months, oil will likely bottom. When the fear wanes, I believe the market will realize that the selling has been way overdone in the other commodities.

Of course, it is difficult to buy into a market like this. Who wants to try to catch a falling knife? That's why the highlighted stock is the bluest of blue chips in its industry. It is one of the most reliable revenue generators of all commodity companies and pays a fat dividend to boot.

Australian-based **BHP Billiton** (**BBL**) is the world's largest diversified natural resource company. This company is an absolute beast in the industry. With a market cap of over $114 billion and revenues exceeding $67 billion (trailing 12-month), it is the biggest player by a significant margin.

BHP Billiton was officially formed in 2001 through a merger between Australian miner BHP Limited and the UK-based Billiton Plc. The current company has a dual listing on the British and Australian exchanges as separate legal entities, but it is managed and run as a single entity.

U.S. American Depositary Receipts (ADRs) trade for each listing — ticker symbol BHP for Australia and BBL for the UK. For our trade, we are choosing the British-listed BBL because there is no withholding tax on dividends for British companies in the U.S.

The company finds, produces, and sells a wide array of industry's most essential raw materials. The market for its products spans the globe from Australia to North America to Europe and Asia.

PICK AT A GLANCE

BHP BILLITON PLC (BBL)

INDUSTRY: Metals and mining

PRICE: $40.53 (as of Jan. 6, 2015)

52-WEEK RANGE: $39.84–$71.44

YIELD: 5.70%

PROFILE: BHP is the world's largest diversified natural resource company.

NOTE: This stock also trades under the ticker BHP, but the UK-listed BBL listing is our target for tax reasons.

POSITIVES

- The company should be financially solid and profitable enough to continue to pay the high dividend even if the environment remains challenging.
- BBL is the epitome of buying a great company while it's out of favor, a typically winning strategy over the long term.
- The stock is poised to perform well when the global economy picks up.

RISKS

- Further weakening of the global economy, if it were in fact to struggle further, would put more pressure on stocks in the commodity sector.
- Commodity prices as a group could have further to fall before finding a floor and regaining strength.
- BHP has a growing presence in China, which is seeing signs of an economic slowdown.

BHP has a highly diversified portfolio of assets that makes it a much more conservative natural resource company than most because it is not overly exposed to any one commodity. In 2014, BHP generated revenues from iron ore, petroleum and potash, copper, coal, aluminum, manganese, and nickel, among others.

Commodity	%
Iron ore	32%
Petroleum and potash	22%
Copper	21%
Coal	13%
Aluminum, manganese, and nickel	12%

As well, most of the company's revenue is generated in developed markets in Australia/New Zealand, North America, and Europe.

But BHP also has a huge and growing presence in Asia, particularly China. In fact, the company recently announced that it sold its one billionth ton of iron ore to China, accrued over a nearly 30-year period.

Focused Efforts

As I mentioned earlier, the huge commodity bull market precipitated by the emerging market boom last decade has come to an end. But BHP, as the most "blue chip" of all natural resource companies, has used its money well and has been well ahead of the curve in adjusting to the new normal.

The company has a below-industry average debt/equity ratio of about 40 percent and enjoys stellar credit ratings, "A" by Standard & Poor's and "A2" from Moody's.

Additionally, a key measure of profitability, return on equity (ROE), is a strong 19 percent, which is well above the industry average and stronger than its major competitors.

BHP has also been taking major steps to get still more out of its existing asset base by shifting focus to efficiency and cost control. The resource giant is simplifying its portfolio of assets, reducing expenses, and increasing productivity and profit margins. Here's more on those efforts.

- **Portfolio simplification**

In an effort to simplify the business, BHP has completed $6.5 billion in divestitures over the past two years. The largest chunk of that is a planned demerger of part of its aluminum, coal, manganese, nickel, and silver assets. BHP intends to spin off a

new company (called South32) around the middle of this year.

These are the less profitable and more economically vulnerable assets. After the spinoff, BHP will reduce costs and get more out of the existing portfolio by retaining just the most productive and highest margin assets. The company will be left with a higher level of free cash flow and an even higher return on equity.

BBL shareholders will receive shares of the new company, which will presumably be listed on the OTC market in the U.S.

- **Cost reductions and productivity gains**

Management is targeting $4 billion in productivity gains by fiscal 2017.

The company will reduce capital and exploration expenses by 32 percent over the next couple of years and cash costs are estimated to be reduced by $2.6 billion by fiscal 2017. Free cash flow is targeted to increase by $8 billion per year over the same period.

Even in a challenging global economy with commodity prices much lower than they have been in several years, BHP has positioned itself to continue to generate solid cash flows and maintain the dividend.

The company reminds me of American corporations after the financial crisis.

They cut costs and got lean and mean to the point where they could generate profits in a rotten economy. When the economy got a little better, profits soared.

BHP is similarly positioned to continue to generate profits and solid cash flow in this miserable commodities market, and it can produce soaring profits if things get better. Moody's recently stated that BHP's sales even in this rough environment "will remain at levels sufficient to generate strong cash flows."

This company is a low-cost producer that can continue to generate solid profits in a low-price environment while many competitors can't. BHP Billiton continued to generate profits and raise the dividend through the financial crisis, a claim few companies can make.

If BHP could weather that storm, it should certainly be able to endure this one.

Considering the Valuation

One of the most compelling reasons to buy BBL is the fact that it is so cheap and out of favor. The stock has taken a beating with the rest of the commodity market and the price has fallen about 40 percent (as of December 31) since the middle of the summer. The stock sells at just 8.4 times trailing earnings compared to its five-year average valuation of 14.

As for its dividend, BHP has a fantastic reputation for paying income. The company has raised the dividend by an average of 17 percent (CAGR) over the past 10 years.

It pays dividends twice per year (March and September), and at the current price the yield is a stellar 5.7 percent with an easily manageable payout ratio just below 50 percent.

Some of you might be concerned that a foreign-based company that generates revenue all over the world could be hurt by the strong U.S. dollar. But the dollar is the world's global currency and BHP usually is paid in dollars. Dollars are the primary source of revenue and the company's reporting currency.

As a result, it determines and prices its dividends in dollar terms. The company's stated policy is to "steadily increase, or at least maintain, our base dividend in U.S. dollars terms at each half-yearly payment."

▸ **Conclusion: Global economic growth has been lousy recently. But the world will continue to demand a sizable and growing quantity of crucial industrial resources.**

Long-term investors could do quite well over time by grabbing this resource giant at a peculiar time when everything has been going against it and the stock is dirt cheap. The stock also pays a high and secure income to investors while they wait for things to turn around.

I recommend buying BHP Billiton plc (BBL) at or below $42 for the Wealth Builder Portfolio.

Sell Alert Review: OSTIX and SJNK

We sold two positions in the Income Strategies Portfolio, **Osterweis Strategic Income Fund** (**OSTIX**) and the **SPDR Barclays Short Term High Yield Bond ETF** (**SJNK**), via email

alert issued on December 17.

OSTIX was originally added to the portfolio on Sept. 25, 2013 at $11.80 per share, while SJNK was added on Feb. 25, 2014 at $31.03. Both positions were unfortunately disappointing for us when all was said and done: OSTIX was sold for $11.25 per share and returned negative 1.19 percent (including dividends), and SJNK was sold for $28.77 and returned negative 3.57 percent in that time (also including dividends).

The reason for the selling is that both funds have high exposure to the high-yield or "junk" bond market, which has taken on a much higher degree of risk since the collapse in oil prices.

The portfolios of both funds are heavily invested in high-yield bonds. Although OSTIX has the flexibility to invest in any kind of bond, 90 percent of the portfolio is invested in high-yield bonds. SJNK is entirely high yield.

Both funds hold short-duration bonds. OSTIX has an average maturity of 4 years and SJNK has an average maturity of 6.4 years. The short duration protects the funds from interest rate risk but still leaves them vulnerable to credit risk.

We added the funds to the portfolio to offer some diversification from stocks while avoiding risks posed by regular (longer-term and investment-grade) bonds.

As our reasoning went, at the time the bigger risk appeared to be rising interest rates (as rates rise, bond prices fall). The Federal Reserve had announced in May of 2013 its intention to end its latest QE3 bond-buying program and interest rates soared as a result.

With the Fed ending its bond-buying program, which effectively held down interest rates, and with the current interest rates still near historic all-time lows, it appeared likely that interest rates would be pressured to rise. High-yield bonds are typically less sensitive to interest rate hikes than investment-grade bonds, and the short-maturity bonds that these funds invest in are also less sensitive to rising rates.

At the same time, high-yield bonds are more sensitive to a slowing economy, but the economy was gaining strength.

In short, these funds addressed the seemingly more likely risk of rising interest rates while providing more exposure to the seemingly less likely credit risk.

But since that point, the opposite situation has unfolded. Because of the deteriorating global economy, interest rates have actually fallen, and in large part because of the sell-off in oil, credit risk is becoming much more prevalent.

Cheaper oil is good in a lot of ways. People pay less for gas and heating oil, and the cost of doing business for companies that use oil goes down. The economy gets a sizable stimulus. But falling oil creates losers as well. One of the losers is the high-yield arena.

As the U.S. oil boom took off, some smaller drillers borrowed heavily to finance operations. These companies leveraged themselves to continue to pump oil out of the ground to sell profitably at much higher price levels than now exist. Many of the companies have below-investment-grade credit ratings and will likely have difficulty paying back the loans.

Energy producers added heavily to the high-yield space in recent years. In fact, energy has come to make up about 16 percent of the Barclays U.S. Corporate High Yield Index, more than double the level in 2008. Energy now has the second largest weighting of any industry in the index.

The likelihood that there is a significant rise in defaults from oil producers affects not only high-yield bonds in the energy space, but the whole high-yield sector. Rising defaults are hitting a market that was largely regarded as overpriced already. The Barclays index went from yielding over 20 percent after the financial crisis to under 5 percent in 2014.

Even Fed Chair Janet Yellen commented during the summer that junk bond valuations are "stretched."

The selling pressure arrived and risk in this particular investing space significantly increased. Once such risk entered these investments, they no longer made sense for us. The economic environment exposed OSTIX and SJNK to enough danger that they no longer provided the intended safe harbor.

If you haven't sold yet, I recommend selling OSTIX and SJNK at market prices upon receipt of this issue.

Best Buys of the Month

"Best buys" highlight what I think are especially good values among all the holdings in our portfolio as we go to press.

The picks are not necessarily those with the cheapest price compared to their recommended "buy in" level. Rather, they're 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
General Motors (GM)	$34.85	$28.82–$40.94	3.44%
Main Street Capital (MAIN)	$28.34	$26.42–$35.72	7.20%

* As of Jan. 6, 2015

General Motors

As discussed in last month's issue, everything is lining up for the U.S. consumer. The employment numbers are the best they've been since the recession, and consumer sentiment and consumer expectations were higher in December than at any time since January 2007.

There is pent-up demand for automobiles as the average age of a car on the road is now over 11 years. People are buying cars. Last year was the best year for auto sales in the U.S. since 2006, and 2015 is forecast to be even better. Looking forward, the average analysts' estimate compiled by Bloomberg for U.S. auto sales in 2015 is 16.7 million vehicles, which would be the most in a decade.

General Motors (GM) has emerged from its 2008 bankruptcy a much more profitable company. Union benefit concessions and plant closings enabled it to slash costs. Labor costs (for hourly employee wages) have shrunk to $5 billion per year from $16 billion in 2005.

The balance sheet is in good shape, with a below industry average debt/equity ratio of less than one. GM's debt is now rated investment grade by Moody's and Standard & Poor's.

These days, GM can remain profitable at levels that previously would have meant billions in losses. For example, the company estimates that it can break even in an environment of about 10.5 million total U.S. sales among all carmakers combined. It's highly unlikely total U.S. sales would fall to that level, even in a very severe recession.

It now has some of the very best cars on the road too. What's more, the good auto market is perfect for GM. Low gas prices are increasing demand for light trucks and SUVs, markets in which GM is dominant. These vehicles are also the most profitable.

Recent troubles with recalls have held back the stock. It is now one of the cheapest and highest-yielding car companies on the market, ahead of what should be a very good year for profits. With all that in mind, I **still recommend GM at or under $36 per share.**

Main Street Capital

Main Street Capital (MAIN) is a business development company (BDC) that makes money by offering high-interest loans and taking equity stakes in up-and-coming enterprises. So naturally the stock does best in times when up-and-coming businesses do well.

A stronger economy with low energy prices and low interest rates should be just what the doctor ordered.

MAIN has historically been one of the best-performing BDCs on the market with an average annual return of about 20 percent per year over the past five years.

The stock should also hold up well in times of rising interest rates, as many of their high-interest-bearing loans are short term or adjustable rate.

But the best part is the dividend. The company yields a solid 7.20 percent with the regular $0.17 per share regular monthly dividend.

But the company also pays a special semiannual dividend of $0.275 per share in addition to the regular payout. Taking that into account, the stock actually yielded a spectacular 8.9 percent over the past 12 months at the current price.

The regular stream of special cash dividends is generated from cash in excess of the distribution. Such an excess bodes very well for the company's ability to continue to generate the current dividend.

I continue to recommend Main Street Capital (MAIN) at or under $32. ■

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	$11.58	$17.50	15.28%	10.81%	2/13/15	-5.87%
Terra Nitrogen	TNH	01-Apr-12	$249.75	$104.00	HOLD	6.85%	2.85%	3/3/15	-43.45%
FLY Leasing Limited	FLY	27-Nov-12	$11.97	$13.09	$14.00	7.64%	8.35%	2/20/15	23.10%
Teekay LNG Partners LP	TGP	20-Dec-12	$38.30	$42.28	$42.00	6.55%	7.23%	3/12/15	25.71%
Prospect Capital	PSEC	26-Feb-13	$11.06	$8.32	$11.50	16.01%	12.04%	1/29/15	-8.29%
Main Street Capital	MAIN	21-Aug-13	$29.21	$28.34	$32.00	7.20%	6.98%	1/20/15	7.73%
LinnCo	LNCO	27-Oct-14	$23.25	$11.31	$25.00	25.68%	12.49%	1/20/15	-50.27%

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	$93.02	$72.00	2.82%	3.93%	1/30/15	49.84%
Eli Lilly	LLY	01-Apr-12	$40.48	$69.72	$52.00	2.81%	4.84%	1/9/15	92.27%
Williams Partners	WPZ	01-May-12	$57.30	$42.18	$58.00	8.80%	6.47%	2/12/15	-2.73%
Vodafone	VOD	27-Sep-12	$28.72	$32.62	$34.00	5.58%	6.34%	6/11/15	16.56%
Intel	INTC	27-Nov-12	$19.98	$35.28	$27.00	2.55%	4.50%	3/3/15	86.90%
Riocan REIT	REI-UN.TO	20-Mar-13	$26.97	$23.34	$29.00	6.07%	5.25%	2/17/15	15.23%
General Mills	GIS	19-Apr-13	$49.94	$52.02	$50.00	3.15%	3.28%	3/3/15	8.37%
Kinder Morgan	KMI	22-May-13	$35.62	$40.83	$38.00	4.90%	5.61%	2/16/15	23.97%
Brookfield Infrastr Ptnrs	BIP	03-Jun-13	$36.00	$41.90	$42.00	4.58%	5.33%	1/28/15	23.44%
Health Care REIT	HCN	15-Aug-13	$60.00	$79.01	$60.00	4.02%	5.30%	2/20/15	38.64%
Realty Income	O	18-Dec-13	$39.14	$50.27	$40.00	4.37%	5.61%	1/22/15	35.73%
Verizon	VZ	21-Feb-14	$47.27	$47.04	HOLD	4.51%	4.48%	2/3/15	1.70%
Northern Tier Energy	NTI	26-Mar-14	$26.00	$21.81	$28.00	18.34%	15.38%	3/2/15	-7.49%
Ventas, Inc.	VTR	23-Apr-14	$64.42	$75.28	$65.00	3.85%	4.50%	3/2/15	20.84%
Textainer	TGH	25-Sep-14	$33.04	$31.40	$40.00	5.99%	5.69%	3/2/15	-4.96%
Deere & Company	DE	07-Oct-14	$80.00	$85.73	$80.00	2.80%	3.00%	2/3/15	7.15%
General Motors	GM	23-Dec-14	$33.43	$34.85	$36.00	3.44%	3.59%	2/4/15	4.25%
Magellan Midstream Ptnrs#	MMP	—	—	$79.35	$65.00	—	—	—	—
Altria Group#	MO	—	—	$48.98	$44.00	—	—	—	—
BUY BHP Billiton#	BBL	—	—	$40.53	$42.00	—	—	—	—

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 Cap Fund	CII	01-Jan-12	$12.50	$13.91	$13.00	8.63%	9.60%	1/29/15	39.95%
Barclays 7.75 Preferred	BCS-PC	27-Sep-12	$25.52	$25.97	Hold	7.86%	7.99%	1/16/15	20.86%
PowerShares Preferred	PGX	24-Oct-12	$14.84	$14.73	Hold	5.95%	5.90%	1/12/15	11.29%
PowerShares Sr Loan Port	BKLN	25-Sep-13	$24.77	$23.86	$25.00	4.02%	3.88%	1/12/15	0.92%
People's United Financial	PBCT	25-Aug-14	$14.90	$14.55	$15.00	4.54%	4.43%	3/17/15	-1.24%
Duke Energy#	DUK	—	—	$84.20	$69.00	—	—	—	—

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. #Denotes recommendation not yet purchased. To see the chart of previous "sold" positions, subscribers can log onto www.highincomefactor.com (under the "Portfolio" tab). All chart data is as of close January 6, 2015.

Closing Thoughts →

The
High Income Factor

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Closing Thoughts

The best times to buy a stock are also the most uncomfortable. It has historically been a fantastic strategy over the long term to buy good companies when they are out of favor. The problem is that when a company is out of favor, there tends to be a higher level of risk that the price will go lower in the short term.

If you can find a strong company with a marketable niche that capitalizes on a powerful trend that is likely to last, it should do well over time. If such a company pays a high yield it's even better. You get paid to wait for the stock to rise.

Commodities have gotten slaughtered of late. Higher supply, the slow global economy, and the strong dollar are all factors conspiring against hard assets in the near term.

But **BHP Billiton** (**BBL**) is a top-shelf, low-cost natural resource company that will continue to benefit from the unmistakable trend of rising global industrialization. The growth rate of natural resource demand may be volatile. Yet the world is consuming more natural resources now than ever before.

Investors who stepped up and bought good companies during the financial crisis took a high risk of being wrong in the short term. But they have been greatly rewarded over time. A global powerhouse like BHP with a 5.7 percent yield should be a long-term winner for those willing to take a chance.

Actions to Take Now

Action No. 1: I recommend buying **BHP Billiton plc** (**BBL**) at or below $42 for the Wealth Builder Portfolio. Note that this stock also trades under the ticker BHP, but the UK-listed BBL is our target for tax reasons, as I explain on Page 7.

Action No. 2: If you have additional capital to deploy, consider **General Motors** (**GM**) at or under $36 per share and **Main Street Capital** (**MAIN**) at or under $32.

Sincerely,

Tom Hutchinson

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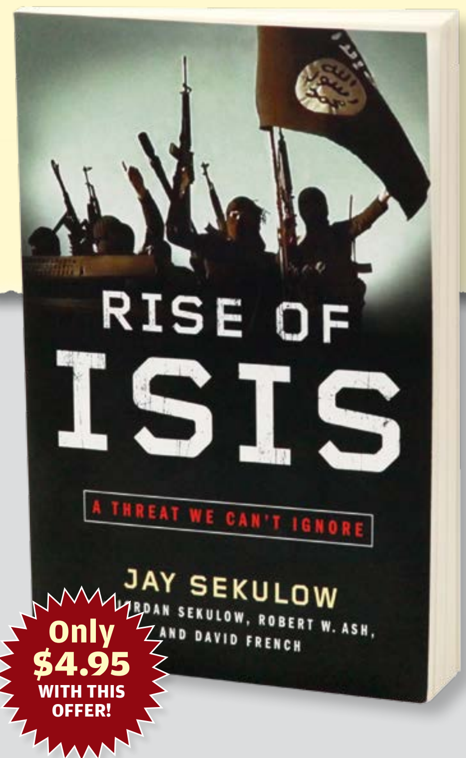
NY TIMES BEST-SELLER

RISE OF ISIS

A THREAT WE CAN'T IGNORE



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- **Terror:** ISIS using its incredible cash flow to build weapons of mass destruction.
- **Troops:** ISIS is recruiting sleeper terrorists in the U.S. and Europe. The threat in the West is so great the Pentagon has advised U.S. military personnel to take extreme precautions.

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