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The
High Income Factor

Unlocking Powerful Strategies to Achieve Superior Returns

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In an Otherwise Expensive Market, a Legendary Income Stock Goes on Sale

It has been a tough market for income investors.

Actually, let me qualify that. It has been a tough market for income investors to put new money to work. It's hard to find dividend-paying investments that aren't overpriced and have a dependable, increasing-over-time payout.

The investors I've spoken with lately all seem to say the same thing. No one trusts this market. And who can blame them? It's tough to muster the courage to chase a market that, as of early December, has already run up nearly 30 percent this year and about 165 percent since the 2009 lows. Coupled with that are treacherous bond and fixed-income investments perched on the edge of disaster, thanks to a likely rise in interest rates.

> "The S&P 500 index may seem too pricey, but certain places within the index are actually, well, cheap."

While stocks have marched to historical heights, the underlying economy hasn't followed suit. To many, it seems like a clear case of stocks racing ahead of fundamentals. Because of this, we have a palpable sense that the hammer will fall on this market in the not-too-distant future, shattering plenty of portfolios in the process.

One of my friends' comments summed up the typical feeling best when he admitted to me, "I'm staying in cash until the market tanks — then maybe I'll get in."

To many, that sounds reasonable. If you think a major downturn or outright crash is coming, why not just wait it out? Unfortunately, such a theory seldom works in practice. The market has a funny way of crushing simple plans.

For instance, what if the market rises another 15 percent while you're parked in cash earning nothing? And suppose stocks do tank in the near future — when do you decide to jump in? If the index falls 10 percent, pundits will line up to say that the market will likely fall 20 percent or more, happily scaring anyone within earshot. In my experience as a financial adviser, most investors who don't like the market here *really* won't like when it's tumbling and the negative opinions are flying.

In the end, unless you're a monumentally lucky market timer, who somehow deftly tucks in just before bull runs and bows out just before the bears parade to the exits, you'll miss a lot of upside over time.

Meanwhile, cash has been a poor investment for the longer term. Over the past 10 years, cash has been the worst performing asset class . . . and that period included two wars and a financial crisis, events that sent money scurrying into savings and money markets.

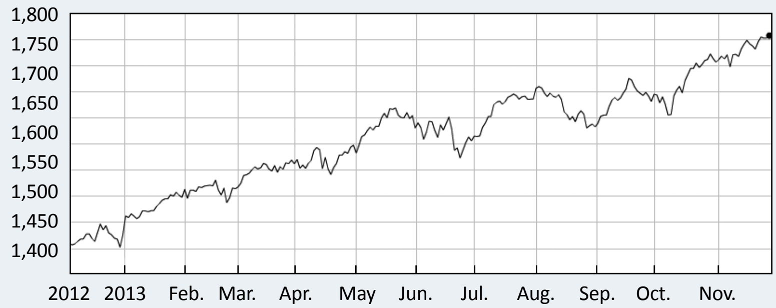
The problem is that the prevailing collective psyche is too negative. The market isn't just one homogeneous entity. It's made up of many different sectors and securities, which don't all move in the same direction. You may believe the S&P 500 index has become too pricey, but certain select places within the index are actually, well, cheap.

In fact, there are sectors of the market and individual securities where that "hammer" has already fallen. In certain areas, the long-feared sell-off has already occurred. One major income-producing sector has experienced its worst correction since the financial crisis, leaving one of the very best income stocks in the history of the market in the bargain bin, just waiting for us to pluck it out.

Let's take a look at just how overpriced the overall market is (or isn't) and why this month's highlighted security is selling at bargain prices despite the overall market environment.

Chart 1

S&P 500 Index, One Year



The S&P 500 index has been on an upward trend all year, but the story has become, "When will the ride come to an end?" Lost in the debate, however, is the fact that not all stocks and sectors have been caught up in the bullishness.

SOURCE: Yahoo Finance

Bubble or No Bubble?

For more than a year now the major market indexes — the Dow Jones and the S&P 500 — have been forging ahead to new all-time highs just about every month. (See Chart 1.) After hearing such news about 10 or 15 times in the course of a year, we naturally think the market is getting ahead of itself and such a string of all-time highs simply has to end.

Even if the market can go still higher, it needs a breather at some point. Nothing goes straight up. And neither index has experienced any kind of significant pullback of 10 percent in more than two years.

All those reasonable thoughts lead to one: Are stocks overpriced and due for a pullback?

The short answer is not really. Of course, the market can always sell off at any time, and a correction would actually be healthy, but stocks are not particularly overpriced at this point.

A commonly used measure of the relative valuation of the market is the price/earnings ratio (P/E), which measures how much you pay for each dollar in annual earnings when you buy a stock. If the P/E of a stock is 10, you're paying $10 for every dollar the company earned per share for the most recent 12-month period. Forward P/E, meanwhile, is a measure of projected earnings in the coming 12-month period.

As of this writing in early December, the S&P 500 is selling at 15.1 times forward earnings. That compares to the average valuation of about 14 times forward earnings over the past 10 years (according to financial data and analytics company FactSet). So, at least by that measure, the market isn't particularly cheap, but it isn't overly expensive either, and it certainly isn't anywhere near bubble territory. (See Chart 2 on Page 3.)

Of course, the forward P/E ratio is based on estimates for earnings over the next year. The actual earnings could be higher or lower. If the economy picks up steam, profits could be well above estimates and lower the P/E ratio. But the reverse is also true. If the economy turns south, so will earnings and likely the market.

In Stocks, Earnings Are Everything

Right now, the earnings situation for 2014 looks promising. The general consensus is that both the U.S. economy and corporate earnings will outpace 2013 levels. FactSet's consensus forecast expects year-over-year S&P 500 earnings growth to increase from an estimated 4.6 percent in 2013 to 10.9 percent in 2014.

That sounds good, but there is an ominous number that also pops up in the forecasts. Revenue growth is estimated to be just 2 percent in 2013. That underlines a very troubling issue.

Corporations have been able to work the bottom line and make per-share profits look better than they truly are. Companies have slashed costs by methods such as laying off workers and reducing research and development. In addition, there has been a rising number of share buybacks helping the bottom line by decreasing the amount of shares outstanding, which increases earnings on a per-share basis. (See Chart 3 on Page 4.)

While getting leaner and meaner can be good, a company can do it for only so long. A business can't grow profits by slashing costs forever. Eventually a company cuts all that can be cut and the only thing that can drive profits is top-line sales or revenue growth. Such growth generally only comes from a better economy.

In short, many S&P 500 companies have pulled out all the tricks to juice profits in a sluggish economy. But that practice is getting old. Profits in the future will have to be driven more by real strength — stock prices will have to be more reflective of the underlying economy. And economic growth has been lame since the financial crisis. The recovery has been the weakest in the post-World War II era, averaging 2.1 percent GDP growth annually.

For stocks to continue to rally beyond the short term in a way that is healthy and sustainable, the economy will have to finally turn the corner. Economic forecasts, for their part, are positive for the next year.

The International Monetary Fund (IMF) is calling for 2.75 percent GDP growth in the United States for 2014 versus just 1.7 percent in 2013. The Federal Reserve Bank predicts 3.1 percent GDP growth compared to 1.75 percent for last year, and Kiplinger's forecasts a year-over-year jump in growth from 1.7 percent to 2.6 percent.

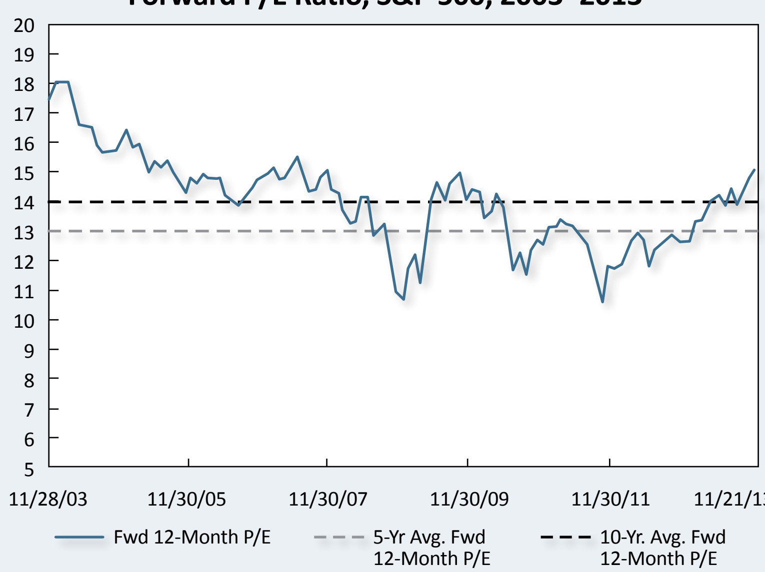
Should the higher earnings materialize, a market rise in 2014 will be a healthy one. But if earnings sputter, the situation could get dicey. Either stock prices will fall . . . or they will continue to rise, despite the lack of earnings, in an unhealthy manner through "multiple expansion."

Multiple expansion occurs when stocks rise without a corresponding rise in earnings. In this scenario, the market simply sells at a higher price/earnings *multiple*. Investors are willing to pay a higher price for stocks, and prices rise on nothing but investor enthusiasm (which can fade as easily as it comes) and the fact that Federal Reserve low-interest-rate policies have left investors with no place else to go for a decent yield. That's when the market treads into bubble territory. But we're not there yet.

So far, the current bull market has been fueled far more by corporate profit growth than that "multiple expansion" scenario. The 165 percent rise in stock prices on this bull run has been based mostly on earnings growth (106 percent) than P/E multiple expansion (up 59 percent).

Chart 2

Forward P/E Ratio, S&P 500, 2003–2013



Worries of a "stock bubble" may be overblown, at least looking at forward price-to-earnings ratios. The S&P 500 is selling at 15.1 times forward earnings, not too far off the average valuation of about 14 times forward earnings in the past decade. In a bubble, you'd expect the P/E to be much higher and perhaps making a parabolic move.

SOURCE: FactSet

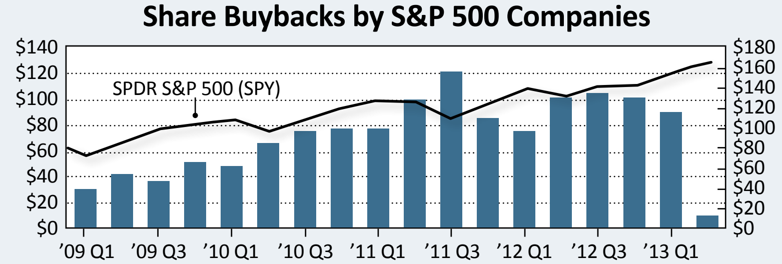
▶ About Tom Hutchinson

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.

Don’t Forget the Fed

The Fed’s easy money policies are holding interest rates down and pumping money into the system. The Fed juice has been a key factor driving the markets higher. By holding interest rates near historic lows, the Fed forces money into stocks because it has no place else to earn a reasonable return. In addition, super-low interest rates have also helped company bottom lines by making it extremely cheap to borrow money.

Chart 3



Share buybacks (represented in “billions” on left “y” axis) have been one factor keeping the overall market’s price-to-earnings ratio from ratcheting up. Companies are pulling shares off the market, thus increasing the earnings of each share that remains.

SOURCE: GuruFocus

But the Fed may soon taper its quantitative easing program. There has been much anticipation over when the Fed will begin cutting back its current $85 billion a month bond-buying program. Fed officials failed to taper in September, and now Janet Yellen has been nominated as the new Fed chair, replacing Ben Bernanke. Many are skeptical that she’ll reduce the bond-buying program anytime soon, but we’ll see. As of now, she is widely expected to advocate tapering in March 2014.

No one really knows for sure how a Fed taper will affect the markets. In any event, it’ll be a delicate dance — withdrawing stimulus too fast or too slow both have negative impacts. I covered this very issue extensively in the July 2013 newsletter. You can refer to that (available at www.highincomefactor.com) for a more in-depth discussion.

The taper presents a huge uncertainty. After all, if Fed policies have been instrumental in driving stock prices higher, what will happen when it starts to shut the money spigot? I believe the Fed will taper in the next six months only if the economy shows concrete signs of turning the corner, and if that happens, I also think the benefits of a strong economy will more than compensate for higher interest rates resulting from a taper.

There’s also a potential win-win situation for stocks regarding the taper. Either the economy takes off, which is good for stocks, or the Fed policies that have been so successful in driving the market higher will continue. However, if the economy languishes and the Fed continues its bond buying, a stock market rise will be based almost exclusively on overzealous money printing and a bubble truly will form in stocks. We’ll see.

As of now, though, stocks are valued a little above average, but not excessively high. Earnings have slowed but are forecast to pick up over the next year. Against that backdrop, the Fed continues to inject easy money into the system and hold interest rates low. There is a good chance that stocks will forge higher in the next year or so, but probably nothing like the 30 percent gains we are seeing in 2013.

An investor’s returns can be greatly enhanced by identifying attractive income stocks at good valuations that are hiding within a slightly pricey market. There is one sector in particular that presents a fantastic opportunity for income investors.

A Shining Gem in a Harder-Hit Income Sector

A stock market correction is defined as a decline of 10 percent in the accompanying index. A bear market is defined as a 20 percent drop. Investors are nervous because it has been a conspicuously long time since the S&P 500 experienced any such drops. But real estate investment trusts (REITs) have already been clobbered.

Owning real estate is a great way to diversify your holdings outside of the stock and bond markets. As a hard asset, real estate maintains and increases value during times of falling dollar values or inflation. Owning property is also a fantastic way to generate regular income by charging rent.

But here's the thing about owning real estate — it's a ton of work. You have to shop for properties, haggle over price, deal with lawyers, pay closing costs, and then you make repairs and find tenants. After all that, you're ready to start your new part-time job as a landlord.

Despite those drawbacks, real estate can still be a great investment. But if that sounds like an awful lot of hassle, there is a much easier way. You can buy shares of a REIT.

A REIT is an entity that uses pooled capital of many investors to purchase and manage income properties. These securities trade on major exchanges just like stocks. Like master limited partnerships (MLPs) and business development companies (BDCs), REITs enjoy special tax privileges whereby they pay no income at the corporate level, provided 90 percent of income is returned to shareholders in the form of dividends. The ability to pay out to shareholders money normally lost to taxes makes REITs among the best income-paying securities on the market.

There is a wide variety of REITs available, ranging from apartments to shopping centers to office complexes to hospitals and an assortment of other commercial projects. In total, there are 226 actively traded REITs on U.S. stock exchanges.

Just like buying physical property yourself, REITs provide ownership in actual real estate assets and provide you with a regular income. Unlike buying physical property yourself, REITs can be purchased with any level of initial investment you decide. You don't have to shell out millions for an apartment building. You can invest $1,000, $5,000, $100,000 or whatever amount you're comfortable with.

As great income stocks in an environment where investors are starving for yield, REITs have been extremely popular over the past several years. In fact, until recently, these investments had outperformed the S&P 500 since the financial crisis. (See Chart 4.)

Then, on May 22, 2013, came the Fed's taper announcement from Chairman Ben Bernanke. In the first month following the announcement, the **MSCI U.S. REIT Index** (**RMZ**) plunged 16 percent. By August the plunge stretched to 19 percent. Things haven't gotten much better since. As of this writing, the MSCI U.S. REIT index is 16 percent below the levels on the eve of the Fed announcement.

Since the taper announcement in May through early December, the S&P 500 has outperformed the REIT index by more than 24 percent.

REITs plunged after the taper talk for a couple of reasons. First, the sector had gotten overpriced. The **Vanguard REIT Index ETF** (**VNQ**), which tracks the MSCI's REIT index, was up more than 260 percent between the 2009 lows and late May, nearly twice the 140 percent move for the S&P 500 over the same period.

The other reason is the fear of rising interest rates. After the Fed's taper announcement, just about every kind of income-generating investment took a hit. Bond prices, dividend-paying stocks, MLPs, BDCs, and REITs all got punished as the market prepared for the era of the Fed exit. The reasoning was that as interest rates rise, the relative value of the yields fall; moreover, investors also gain a higher-paying alternative in fixed income.

In addition to the above-mentioned risks to any income security, REITs have other vulnerabilities to

Chart 4

MSCI U.S. REIT Index (RMZ), 2009–2013

Real Estate Investment Trusts as a group outperformed the S&P 500 in the years since the 2008 financial crisis, often by a wide margin . . . that is, until May of 2013, when the Federal Reserve began talking about tapering its quantitative easing program, knocking the price of REITs down across the board.

SOURCE: Yahoo Finance

rising rates. For one, as a tax-advantaged security, REITs pay out 90 percent of earnings in the form of dividends. Since money earned is paid out, the only way to raise money for expansion is by issuing more stock or borrowing money. Higher rates on borrowed money will raise the cost of capital and potentially lower profits. In addition, rising mortgage rates can lower demand — and prices — of real estate, thereby reducing the book value of the REITs' assets.

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.

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.

As I've mentioned in previous issues of this newsletter, bonds and dividend-paying stocks that don't offer growth, like utilities and telecoms, will likely perform poorly if and when interest rates start to rise. But companies that can grow earnings and payouts should continue to fare well. Many REITs have an excellent track record of consistently growing dividends.

In fact, Chart 5 shows that REITs as a group more than quadrupled the size of the yearly dividend in the 20 years between 1992 and 2012.

The beautiful thing is that in a broad sell-off like we've just experienced, you can pluck the very best stocks in the sector. One in particular stands out above the rest.

Realty Income (**O**) is one of the highest-quality and best-run REITs on the market. Cash flow from a conservative portfolio of 3,800 retail properties in 49 states has enabled the company to amass a phenomenal track record of paying dividends; to such an extent that Realty Income actually refers to itself as "The Monthly Dividend Company."

An investor would be hard pressed to find a more reliable dividend payer and grower than this exceptional REIT. Realty has paid 518 consecutive dividends throughout its 44-year operating history dating back to 1969. And the monthly payout has been raised 73 times during that period. In fact, dividends increased every single quarter from 1994 to 2012, and by an average of about 7 percent per year. (See Chart 6.)

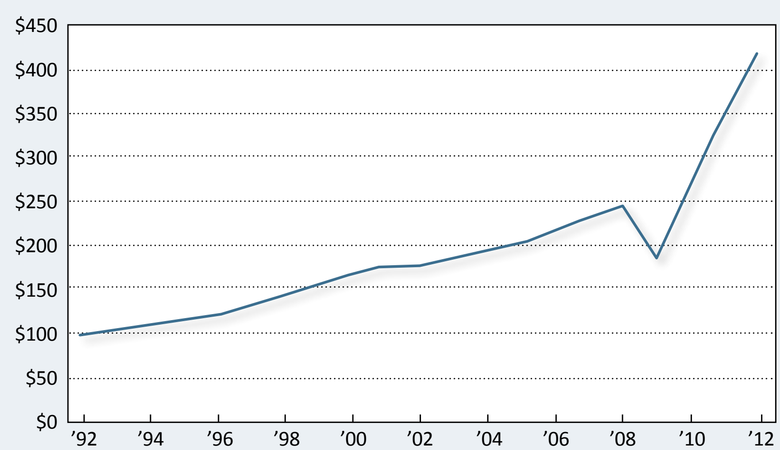
Because of a recent fall in price and a dividend increase of 23 percent over past year, O is currently paying a phenomenal 5.6 percent yield. How does it do it?

The company buys established properties (it doesn't build new ones) with a proven record of profitability and high-quality tenants (72 percent of which have investment-grade ratings). The business model is to generally use a "sale-leaseback" arrangement, whereby Realty Income purchases the property from the tenant and then that company remains there and pays rent under long-term leases of 10 to 20 years.

Most of these leases are "net leases," meaning the lessees pay all the costs associated with the property, including maintenance, insurance, and taxes. This arrangement frees Realty Income from unpredictable expenses. The REIT just receives regular rent payments with built-in increases over time; in other words, a steady and predictable cash flow.

Chart 5

REITs' Two Decades of Strong Dividend Growth



REIT dividends have been on the rise for 20 years, paying out $423 in 2012 for every $100 they paid out back in 1992.

SOURCE: Seeking Alpha

PICK AT A GLANCE

REALTY INCOME (O)

SECURITY TYPE: REIT
CATEGORY: Retail properties
PRICE: $37.60 (as of Dec. 3, 2013)
52-WEEK RANGE: $36.58–$55.48
YIELD: 5.6%
PROFILE: Realty Income operates a highly diversified portfolio of retail properties throughout the country and is considered one of the all-stars in the industry.

POSITIVES

- The stock has an amazing track record of dividend growth.
- Realty's conservative business model provides an excellent basis for investors seeking reliable income.
- The stock is selling near its 52-week low and about 32 percent below its 52-week high, representing a rare opportunity for income investors in this market.

RISKS

- REITs as a group were clobbered when the Federal Reserve chair Ben Bernanke initially announced taper plans — and unlike 2013, the Fed is likely to follow through with a bond-purchase taper in 2014.
- Rents and prices for retail real estate would be impacted if the U.S. or global economy turns south for any length of time.

Broad diversification also limits risk. Realty invests overwhelmingly in retail properties and the portfolio is spread out in the following ways.

- 3,800 properties
- 46 different industries
- 194 separate enterprises
- Properties in 49 states and Puerto Rico

The top 15 tenants account for only about 44 percent of the total portfolio and include some of the most established national and regional franchises in the country. Realty Income also boasts a phenomenal 98.1 percent occupancy rate on its properties (as of last quarter), far higher than the industry averages.

Realty Income's Stellar Track Record

Realty Income stock has continuously generated solid returns for investors. The average annual return for Realty Income over the past 15 years has been about 11 percent, and it has been 10.5 percent for the past 10 years, compared to 4.9 percent and 7.9 percent for the S&P 500 for the same respective periods. Since 1994, Realty Income has averaged a whopping 16.8 percent average annual return (as of Sept. 30, 2013) versus just 10.7 percent for REITs overall and 9 percent for the S&P 500 over the same period.

But it can be hard to derive much meaning from these numbers. A real-life example should give you a better idea of the power of dividend income. Let's say you invested $20,000 in Realty Income stock on the last day of 2003. Also assume that you never added money to the position and took the dividends in income. Over the next roughly 10 years (until Sept. 30, 2013), you would have received $15,786 in dividends, equating to about 79 percent of the value of the initial investment. Your quarterly dividends would have increased from $1,200 per share to $2,182, and you would now be receiving a 10.9 percent yield on your initial investment.

In addition to receiving $15,786 in dividends, the value of your shares would have about doubled to $39,750. So, you would have received 79 percent of the initial investment in income and the value of the shares would have about doubled. All totaled, between price appreciation and income, you would have $55,536 from the initial $20,000 investment in a little less than 10 years. And that time period included the financial crisis.

What's Ahead?

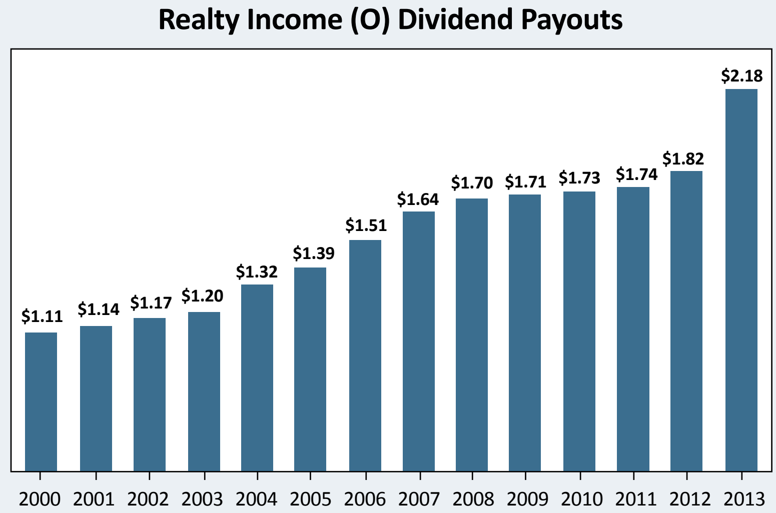
Sure, those results are great, but that's in the past. Let's take a look at the prospects of Realty Income delivering similar returns in the future.

A REIT has essentially two ways to grow earnings and the dividend: higher rents from existing customers and accretive acquisitions. In the first nine months of the year, Realty invested about $1.5 billion in new properties, including a large acquisition of **American Realty Capital Trust** (**ARCT**). Because of the acquisitions, as well as 1.3 percent in automatic rent increases, revenue soared 70 percent in the third quarter versus the same quarter last year. More importantly, on a per-share basis, funds from operations (FFO), a more accurate profitability measure than net income for REITs, increased a stellar 13.5 percent year over year.

Here's why the per-share number is so important. Since REITs pay out 90 percent of income in the form of dividends, they need to either borrow money or issue more shares to get the capital to expand. Realty issued stock primarily to raise money for this year's acquisition. While new issuances dilute existing shareholdings, if the company can use the money to increase profits on a per-share basis, shareholder value and dividends increase.

Looking ahead, Realty raised an additional $1.1 billion in the third quarter alone for new acquisitions. The REIT also has one of the most fundamentally solid balance sheets in the industry, with just a 35 percent debt-to-equity ratio. So, the company has plenty of ability to borrow money for acquisitions as well. Realty Income is targeting 5 percent to 8 percent FFO in 2014 and the REIT has a strong reputation of meeting or exceeding expectations. The business seems poised to deliver results on par with the past in the foreseeable future.

Chart 6



Realty Income (O) has been an income-generating powerhouse for years. It has paid 518 consecutive dividends throughout its 44-year operating history, dating back to 1969. Its monthly payout has been raised 73 times during that period.

SOURCE: Realty Income

Like the rest of the REIT sector, Realty took a huge hit after the Fed's taper announcement in May and has been limping ever since. The stock is about 32 percent below its 52-week high as of this writing, and it is selling at a reasonable valuation (about 15 times estimated 2014 FFO) for such a prolific income-generating security in this environment.

▸ **Conclusion: Because of a series of weird phenomena, one of the best income stocks on the market has become relatively cheap in a market that is starved for income. Although it had grown overvalued along with the rest of the REITs, it has been whacked back down in a way I believe more than compensates. This stock has a fantastic track record, stellar fundamentals, and promising dividend-growth prospects. Realty Income (O) is one of the more low-risk options for income in the market right now. I recommend Realty Income for the Wealth Builder Portfolio, at or below $40 per share.**

Portfolio Updates

Seadrill Limited (SDRL)

Offshore driller Seadrill Limited saw its stock price fall 6 percent after a disappointing earnings announcement on November 25. I think the sell-off was overblown.

In the third quarter, revenues for Seadrill exceeded consensus estimates, but earnings per share (EPS) fell short. Revenue of $1.28 billion beat estimates of $1.25 billion and represented a 17.2 percent increase over last year's third quarter. An EPS of $0.61 missed consensus estimates of $0.64, but it was a 50 percent increase over the year-ago third-quarter earnings of $0.40.

In my view, there is nothing particularly troubling in these numbers. Earnings were a little lower than the lofty expectations because of the expense of putting new rigs into service and consolidation of a recent acquisition (the second-quarter purchase of Sevan's Drilling operations). In my view, revenues are more important because they are more reflective of future earnings potential. And revenues exceeded even the high expectations.

Also, expressing confidence in future earnings, the company increased the quarterly dividend to $0.95 per share, payable on December 20. The payout hike was 4.4 percent over last quarter and is the third dividend hike this year. At the current price, Seadrill yields a whopping 8.7 percent.

The thing is, Seadrill is a gunslinging maverick in the offshore drilling space and it's the type of stock the market falls in and out of love with periodically. With oil prices falling, the market is in a foul mood when it comes to earnings misses for aggressive energy companies.

Let's briefly review the Seadrill story. The easy oil is gone and new oil is being found in harder-to-reach places like rock formations and miles below the sea floor. Seadrill offers the largest and most modern fleet of deep-water and ultra-deep-water drilling rigs on the market. These rigs have been in high demand (and contracts are fetching high prices) as offshore oil discoveries have soared over the past several years.

But Seadrill carries some risks. It has attacked the deep-sea drilling market with reckless abandon, taking on excessive debt to quickly build a fleet to meet rising demand, often before even securing contracts on new builds. So far the strategy has worked, as demand for these rigs has remained strong. But the company's balance sheet is a bit of a mess with a relatively high debt/equity ratio of 1.5 and a volatile cash flow.

By paying such a high dividend, Seadrill is forced to borrow a lot of money to fund its ambitious pipeline of new projects. Either preference or necessity could persuade management to cut the dividend going forward, which would be bad for the stock price in the near term. A significant economic downturn, and the corresponding decrease in demand for deep-sea rigs, could also tank the stock in the near term. A prolonged slump in oil demand and price could bankrupt the company. But, as I don't believe the world will move away from oil anytime soon, I still like SDRL.

The future looks promising. Seadrill has 64 rigs currently in operation and the fleet is already 93 percent contracted for 2014. Most of the contracts are also with highly reputable companies that can be counted on to follow through. In the table is a list of Seadrill's main clients and the corresponding percentage of revenue each generates:

Oil Company	% of Seadrill Revenue
BP plc (BP)	25%
Total (TOT)	14%
Exxon Mobil Corp. (XOM)	11%
Statoil (STO)	9%
Petrobras (PBR)	7%

Seadrill has another 27 rigs being built and slated into operation in the next five years.

Still, this stock is not for the faint of heart. Even if things go well, it might be a wild ride and is really only advisable for those who are comfortable with a more aggressive holding.

Terra Nitrogen (TNH)

Fertilizer company **Terra Nitrogen Company LP** (**TNH**) has had a rough time lately. The stock price fell more than 30 percent between mid-August and November and 23 percent in the month of November alone.

The partnership recently announced third-quarter earnings 80 percent lower than last year's third quarter and announced a distribution of $2.02 (payable on November 29 to holders of record on November 15), which is less than half the third-quarter distribution last year ($4.11).

The problem is that fertilizer is a commodity and commodity prices are volatile. Fertilizer prices have tumbled recently because of the recent breakup of a Russian cartel that had supported global fertilizer prices, increased capacity in China, and falling corn prices. Lower corn prices result in lower demand for fertilizer as farmers plant less.

The stock had absorbed this news without too much downside. But a more severe sell-off was triggered weeks later by an Environmental Protection Agency (EPA) announcement.

The EPA confirmed that it would indeed reduce the amount of ethanol it requires to be blended with gasoline in 2014 — the Energy Independence and Security Act of 2007 mandated 14.4 billion gallons of corn-based ethanol be blended in the U.S. motor fuel supply in 2014, but sagging demand has led to a proposed decrease to 13.2 billion.

Corn is the main crop used for ethanol production, and this change equates to a drop in demand of about 275 million bushels of corn, the highest nitrogen-consuming field crop.

Corn and fertilizer prices plunged in the aftermath, and TNH stock fell far more than fertilizer producers that aren't MLPs. The reason is that MLPs pay out earnings in the form of distributions, and unlike regular corporations that can weather the storm and maintain dividends from cash on hand, TNH pays distributions from earnings. As earnings fall, so will the payout. A falling payout means falling prices.

That said, fertilizer prices won't remain low indefinitely. In fact, as of this writing, prices have already started to recover somewhat.

This stock deals in a commodity, and commodity prices are notoriously volatile. Various factors affect the price of fertilizer, including weather, global demand, and natural gas input prices. We are seeing the downside of that volatility now. But things can change fast and the long-term prognosis for nitrogen fertilizer and Terra Nitrogen is still excellent.

Terra is perfectly positioned to benefit from an undeniable trend going forward: the increasing global demand for food. The company provides nitrogen fertilizer that is crucial to increase corn crop yield, and corn is one of the world's most vital foods. TNH is one of the few U.S. providers of fertilizer and enjoys a profit margin of 74 percent.

But the volatility could continue for a while. Short-term investors may want to wait for a likely bounce up and then exit the position.

I'd suggest that longer-term investors continue to hold the stock and collect the dividend, as this business should recover in the quarters and years ahead. As far as the official High Income Portfolio, TNH remains a "buy."

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 High Income Factor. They're the answer to the question, "If I were just starting to investing in the High Income Factor Portfolio, which first securities would I buy first?"

NOVEMBER BEST BUYS			
Security	Price*	52-Week Range	Yield
Health Care REIT (HCN)	$55.34	$55.34–$80.07	5.5%
Kinder Morgan Energy Partners (KMP)	$81.62	$77.60–$92.99	6.6%
Terra Nitrogen (TNH)	$154.25	$151.15–$256.50	9.3%

* As of Dec. 3, 2013

Health Care REIT (HCN): This operator of senior living and medical properties has been clobbered along with many other REITs. The stock is currently selling at its 52-week low and about 30 percent below its 12-month high.

The recent market overreaction has created a great entry opportunity for long-term investors seeking reliable cash flow. HCN is perfectly positioned to benefit from perhaps the most pronounced mega trend 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 of acquisitions were made in the second quarter of 2013. The acquisitions are bearing fruit, as revenues soared 55 percent in the second quarter and 72 percent in the third quarter.

The company recently reaffirmed its full year 2013 outlook of 5 percent to 8 percent per-share earnings growth. With a 5.5 percent yield and a solid, predictable revenue stream going forward, HCN continues to be promising and worth accumulating under $60.

Kinder Morgan Energy Partners (KMP): KMP is one of the best MLPs on the market with a phenomenal track record of distribution growth and financial stewardship.

Kinder Morgan is invested heavily in projects that should capitalize on the bounty of the American energy renaissance and serve as a catalyst for future growth. Also, the partnership has a stellar track record of earnings and distribution growth.

The stock is yielding a fantastic 6.6 percent and is selling more than 12 percent below it 52-week high. The company also announced positive third-quarter earnings and again raised its distribution. The recent overblown bad press that knocked Kinder back on its heels price-wise has presented a buying opportunity for long-term investors.

Terra Nitrogen (TNH): I just covered the Terra Nitrogen situation in depth. I believe this a great time for long-range investors to take advantage of the downside of commodity volatility and pick up this high-yielding stock with a great future. ■

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	$16.70	$16.50	10.60%	10.81%	2/13/14	22.52%
SeaDrill	SDRL	01-Feb-12	$35.24	$41.84	$36.00	8.70%	10.33%	12/20/13	38.59%
Terra Nitrogen	TNH	01-Apr-12	$249.75	$154.25	$255.00	9.30%	5.75%	3/3/14	-20.66%
Legacy Reserves LP	LGCY	01-Sep-12	$27.78	$27.36	$29.00	8.55%	8.42%	2/14/14	14.78%
FLY Leasing Limited	FLY	27-Nov-12	$11.97	$15.25	$16.00	5.77%	7.35%	2/20/14	33.52%
Teekay LNG Partners LP	TGP	20-Dec-12	$38.30	$39.70	$39.00	6.80%	7.05%	2/12/14	10.49%
Prospect Capital	PSEC	26-Feb-13	$11.06	$11.13	$11.50	11.95%	12.03%	12/20/13	11.21%
Main Street Capital	MAIN	21-Aug-13	$29.21	$31.78	$31.00	6.23%	6.78%	2/15/14	11.28%

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	$83.80	$72.00	2.71%	3.40%	1/30/14	31.21%
Eli Lilly	LLY	01-Apr-12	$40.48	$49.78	$52.00	3.94%	4.84%	12/10/13	31.92%
Williams Partners	WPZ	01-May-12	$57.30	$49.96	$58.00	7.03%	6.13%	2/12/14	6.13%
Vodaphone	VOD	27-Sep-12	$28.72	$36.97	$34.00	4.36%	5.61%	2/7/14	31.97%
Intel	INTC	27-Nov-12	$19.98	$23.55	$23.00	3.82%	4.50%	3/3/14	21.74%
Philip Morris	PM	04-Feb-13	$87.00	$85.76	$87.00	4.38%	4.32%	1/14/14	1.51%
Riocan REIT	REI-UN.TO	20-Mar-13	$26.97	$22.69	$29.00	6.19%	5.21%	2/10/14	-3.90%
General Mills	GIS	19-Apr-13	$49.94	$50.60	$50.00	3.00%	3.04%	3/3/14	2.91%
Kndr Mrgan Enrgy Prtners	KMP	22-May-13	$88.50	$81.62	$88.50	6.62%	6.10%	2/14/14	-6.23%
Brookfield Infrastr Ptnrs	BIP	03-Jun-13	$36.00	$37.89	$40.00	4.54%	4.78%	1/28/14	6.52%
Health Care REIT	HCN	15-Aug-13	$60.00	$55.34	$60.00	5.53%	5.10%	2/20/14	-6.58%
BP plc	BP	22-Nov-13	$47.65	$46.58	$50.00	4.84%	4.78%	12/20/13	-2.25%
Magellan Midstream Ptnrs#	MMP	—	—	$61.58	$49.00	3.60%	—	—	—
Deere & Company#	DE	—	—	$82.71	$80.00	2.40%	—	—	—
NEW Realty Income#	O	—	—	$37.60	$40.00	5.60%	—	—	—

#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
Blkck Enhanced Cap Fund	CII	01-Jan-12	$12.50	$13.64	$13.00	8.80%	9.60%	1/30/14	26.27%
Barclay's 7.75 Preferred	BCS-PC	27-Sep-12	$25.52	$25.31	Hold	8.06%	7.99%	12/16/13	9.17%
PowerShares Preferred	PGX	24-Oct-12	$14.84	$13.72	Hold	6.47%	5.98%	3/3/14	-1.98%
Osterweis Strat Inc	OSTIX	25-Sep-13	$11.80	$11.95	$12.00	5.00%	5.07%	12/17/13	1.27%
PowerShs Sr Loan Port	BKLN	25-Sep-13	$24.77	$24.85	$25.00	4.06%	4.07%	3/3/14	1.00%
WisTree Emrg Mkts Eq Inc	DEM	23-Oct-13	$53.87	$50.60	$56.00	4.04%	3.80%	12/27/13	-6.07%

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.

As of close Dec. 3, 2014

SOLD POSITIONS

Recommendation	Ticker	Portfolio	Entry Date	Entry Price	Exit Date	Sell Price	Total Return
American Cap Agcy 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-Pac Inc Fund	FAX	Income Strat	01-Aug-12	$7.83	05-Jun-13	$6.55	-13.55%
Pimco Income Opp Fund	PKO	Income Strat	01-Dec-11	$25.64	03-Jul-13	$28.00	23.09%
Pshares Ins Nat'l Muni	PZA	Income Strat	01-Aug-12	$25.72	10-Oct-13	$22.99	-7.19%

The
High Income Factor

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Closing Thoughts

The market may be slightly pricey but it's certainly not in a bubble. There are plenty of good reasons for stocks to forge still higher in the year ahead after a strong 2013. But no one can reasonably expect the market to deliver the kind of returns it did these past 12 months.

However, despite the overall runup, certain segments of the market are cheap at this point. By identifying these discounted opportunities, we can still capture outsized investment returns in the months and years ahead.

There happens to be one such gem in the income realm, a real estate investment trust to be more specific. An overreaction to the Federal Reserve's "taper threat" has knocked the high income REIT sector down to reasonable prices. Arguably the very best income stock in the sector, Realty Income is especially attractive.

Realty Income (**O**) pays a reliable monthly income that has consistently grown over decades. While everybody else is whining about a bubble, you can shrug off those overall stock market worries and secure a 5.6 percent yield in one of the best income vehicles on the market today. It's a wonderful addition to our Wealth Builder Portfolio.

Actions to Take Now

Action No. 1: Watch for an opportunity to buy **Realty Income** (**O**) for the Wealth Builder Portfolio, at or below $40 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 interesting right now: **Health Care REIT** (**HCN**) at or under $60, **Kinder Morgan Energy Partners** (**KMP**) at or under $88.50 and **Terra Nitrogen** (**TNH**) at or under $255.

Sincerely,

Tom Hutchinson

What Does Your Belly Fat Say About Your New Year's Resolution?

Statistics indicate that losing weight is our top New Year's resolution. This isn't surprising, since nearly 70% of Americans are at least somewhat overweight.

However, when it comes to losing weight, what most often comes to mind is the fat pad just beneath your skin, known as subcutaneous fat. Whether you call it a muffin top, pot belly, or love handles, this type of belly fat is certainly an unsightly cosmetic issue — as well as a sign of less-than-optimal health.

The Fat You Can't See — And Why You Should Care

More detrimental to your health, however, is the belly fat you can't see — the deeper visceral fat surrounding your internal organs, or viscera. This fat produces hormones and other chemical substances increasing your risk for health concerns related to your heart, your blood sugar, and other body systems.

Carrying around too much visceral fat presents even more health risks for men and women over 40, who have a much harder time dropping weight.

While a healthy diet and exercise are the foundation of weight loss, sometimes more help is necessary. A high-quality, natural weight-loss supplement may be just what you need to put a jump-start into your weight loss efforts — and lose both kinds of belly fat.

Metabio™ to the Rescue — Just in Time for New Year's

Metabio™ is an all-natural premium nutritional supplement with 5 hand-picked ingredients specifically targeted toward regaining and maintaining your optimal weight and wellness when used as part of a healthy lifestyle, including proper diet and regular exercise.

When taken as part of a reduced-calorie diet and exercise program, these 5 ingredients in **Metabio™** support sensible weight loss and a healthy metabolism, promote fat loss, and help support insulin sensitivity.

In this formula, derived from extensive research on weight and metabolism, you'll find:

- ***Svetol®* Green Coffee Bean Extract – slows the release of glucose into the blood**
- **Raspberry Ketones – may help burn fat**
- **Chromium – helps improve the body's use of insulin**
- **Green Tea Leaf Extract – helps increase metabolism**
- ***Bioperine®* Black Pepper Extract – helps improve absorption of certain nutrients**

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For a limited time, you can get a complimentary **30-day supply of Metabio™** (a $39.95 value). You just cover a low shipping fee of $4.95 (other terms and conditions apply).

Plus, you'll also receive the **FREE** report, ***A Practical Guide to Healthy Weight Management*** ($20 value), packed with practical advice on healthy weight loss, top nutrients for healthy weight management, and how to pick a diet plan.

For complete details on claiming your own 30-day supply of **Metabio™** and Special Report, please sign up right now online, or call our representatives toll-free at the number below.

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Or Order By Phone: (800) 500-4325 and mention special offer code "FatLoss"

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