

Big Profits from One of the Most Elegantly Simple Business Models I've Seen

One of my favorite books is Sun Tzu's "The Art of War."

Usually you'll find this tome on the shelves of CEOs and other business leaders. But I believe the book's age-old wisdom equally applies to investing.

One passage particularly comes to mind when I consider today's investing landscape:

"Avoid what is strong, and strike at what is weak."

Put more directly, investing today requires a targeted approach. The markets are coming off one of their best years ever -- many firms have enjoyed significant appreciation in their share prices.

These "strong" firms are now faced with less likelihood of gains ahead. There's only so high trading multiples can reasonably rise.

These well-performing companies also carry greater risk of loss -- if sentiment changes and multiples contract.

Such a shift in investor outlook is already underway. Today, there are numerous doubts about economic growth -- both globally and in America. Just look at concern lately over tapering by the Fed and whether it will dampen corporate profits.

With pitfalls like this lurking, it's perilous to simply make bets on "the economy" or "corporate America." We're just not in the sort of robust economy where a rising tide lifts all boats.

Rather, corporations today must stand on their own merits. Investors have to be discerning in picking sectors and companies where solid fundamentals -- combined with reasonable valuations -- create potential for gains.

Commodities, for example, have swung to the undervalued end of the spectrum, despite very good business performance from many firms in this space, which is why we're starting to see significant gains in the sector. My own *Top 10 Stocks* portfolio has benefited -- with last month's top pick Alcoa (NYSE: [AA](#)) having gained 13% since December 5.

Gains like this will continue to be available in today's stock-pickers' market. But it requires us to look hard for attractive sectors and companies.

In terms of choosing sectors, my colleague Michael J. Carr published some critical signposts last month in his [Maximum Profit](#) advisory.

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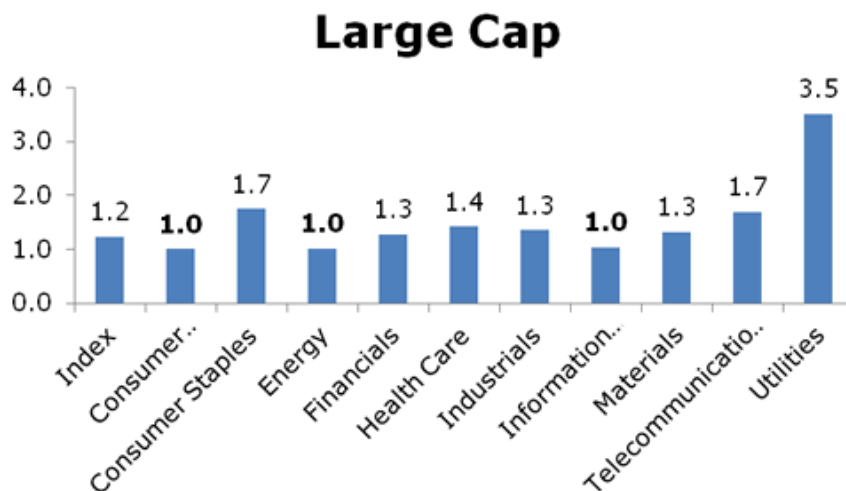
[Buy These Stocks First](#)

For anyone not familiar with Michael's highly regarded research, he publishes some of the most insightful notes on trading I've come across. His career has focused on identifying stocks where a confluence of fundamental indicators point to big upside in particular stocks.

Last month, Michael published the chart below. In it, he looks at what the numbers are telling us about the potential of various sectors.

To figure out where the best opportunities lie, this work goes beyond conventional analysis. Using a sophisticated metric called the PEG ratio -- which compares current valuations (as measured by P/E ratios) with growth potential.

A low PEG ratio indicates firms selling at low valuations compared to their future growth prospects. In other words, sectors where we can buy big future earnings at low prices.



As you can see, Michael's chart shows not all sectors are trading equally today.

For example, utility stocks have enjoyed tremendous favor among investors of late, to the point where these stocks command a PEG ratio of 3.5. That's more than double that of the next-highest sectors, indicating a space where investors are paying a lot for growth.

By contrast, sectors like information technology are selling at a rock-bottom PEG ratio of 1.0. Current valuations reflect very little of the growth coming in this burgeoning sector.

That's a big reason why my *Top 10 Stocks* portfolio features stocks like Intel (Nasdaq: [INTC](#)) and Cisco (Nasdaq: [CSCO](#)) as top picks. These companies today trade at very attractive multiples to their considerable cash flows -- especially given the commanding positions they hold within their industries.

These Two Numbers Suggest An Important Market Shift is Underway

But where else might we find attractive investments today?

I believe Michael's chart gives us a big pointer -- specifically, the gaping discrepancy in the consumer sectors.

You see, companies that make and sell consumer goods are typically divided into two groups: consumer staples and consumer discretionary.

As the name suggests, the consumer staples sector consists of companies that sell the most basic items -- firms that make toothpaste, like Colgate Palmolive (NYSE: [CL](#)), or laundry detergent, like Procter & Gamble (NYSE: [PG](#)). Today, the S&P also puts firms like Coca-Cola (NYSE: [KO](#)) and Philip Morris (NYSE: [PM](#)) into the consumer staples bag. Ditto companies that retail these products, such as Wal-Mart (NYSE: [WMT](#)) and Costco

(Nasdaq: [COST](#)).

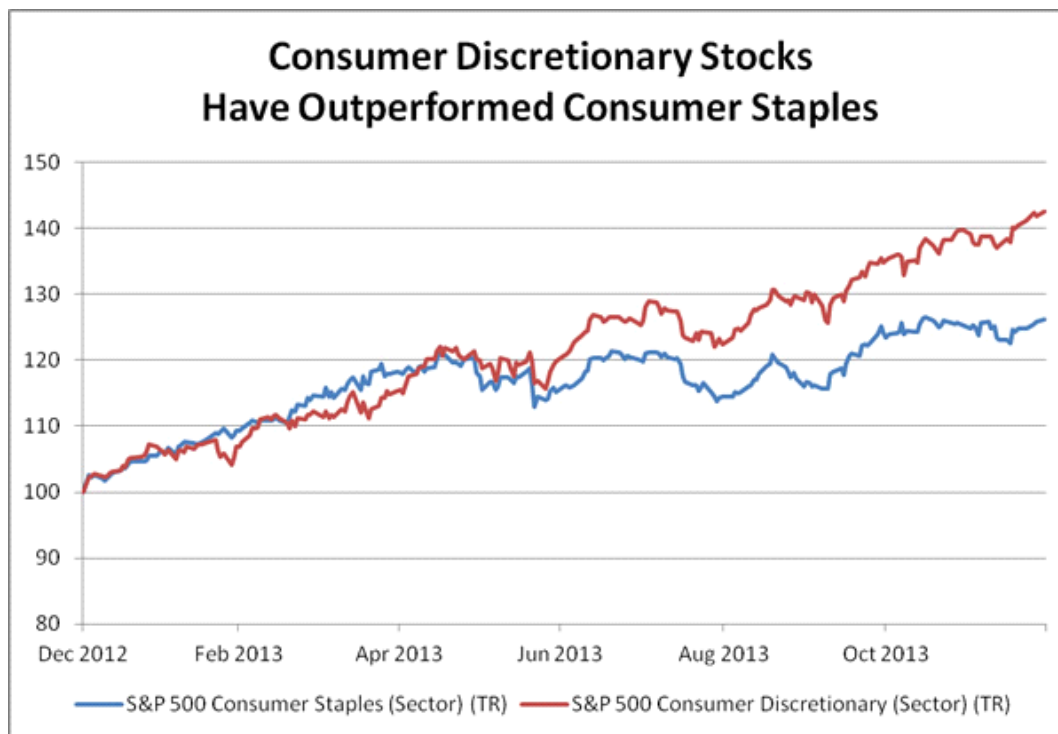
Then we have the consumer discretionary companies: These are the firms specializing in goods people buy when they have extra cash to throw around -- food companies like McDonald's (NYSE: [MCD](#)) and Starbucks (Nasdaq: [SBUX](#)), clothing firms like Nike (NYSE: [NKE](#)), and even motion picture makers like Twenty-First Century Fox (Nasdaq: [FOX](#)).

Investors tend to view these two groups very differently. During tougher economic times, consumer staples perform better. Stock buyers figure consumers will continue to purchase basic necessities, even if tightening budgets force them to cut back on luxuries.

That's been the case of late. With the economy being shaky, investors have been looking to the safety of the consumer staples sector, which is why Michael's chart shows the sector having one of the highest valuations relative to growth, with a PEG ratio of 1.7.

That's a high price to pay for safety, especially now that the economy appears to be regaining its footing -- perhaps signaling that consumers may once again begin channeling significant income toward discretionary items.

That's led to a recent shift in investing patterns. As the chart below shows, starting around May 2013, investors began moving to consumer discretionary stocks. Over the past six months, discretionary stocks have roared ahead of staples, outperforming these safer consumer stocks by nearly 20%.



This trend may just be getting started. Michael's chart shows that consumer discretionary stocks today have one of the lowest PEG ratios going, at just 1.0. Buyers here are paying bargain prices for good growth prospects.

So is it time to jump to consumer discretionary stocks?

Not necessarily.

To be sure, I'm not completely averse to the sector. We've done very well with discretionary firms like Starbucks, which has yielded a 50% gain for the portfolio.

However, we purchased that company well before the stellar run that discretionary stocks have seen over the past six months. Buying such companies today, we're paying a much higher price than we were back then.

That's concerning -- especially given that the fate of discretionary stocks hinges on the

performance of the wider economy.

If things are indeed making a turnaround (which is, after all, the stated reason for the Federal Reserve's planned end to fiscal stimulus), the future should be bright for discretionary goods. We should expect income for these companies to continue to grow.

But is it a lock that the economy will get better? I believe the question is still open.

There are a number of potential minefields continuing to dog the fiscal system, such as the global derivatives industry -- with \$693 trillion worth of what Warren Buffett referred to as "financial weapons of mass destruction" still outstanding around the world.

Regulators are pushing hard to bring this shadowy corner of the financial world into the daylight by creating a slew of new regulations on the trading of derivatives.

I'm not sure what the effect of these regulations will be. In fact, I don't believe anyone knows -- including the folks at the Commodity Futures Trading Commission who designed and implemented the new rules.

But when numbers like \$693 trillion are involved, I'm cautious. We saw this movie before when new "mark to market" accounting rules in 2007 helped to trigger the financial crash of 2008. Sometimes even the most well-intended regulations have unintended consequences.

That's why I'm very judicious about my portfolio. Judicious in seeking upside -- but also protecting against downside. I want stocks that will benefit if the economy picks up but won't be overly harmed if leaner times prevail.

Reaping Gains in Consumer Goods... Without The Risk

One of the big advantages here at StreetAuthority is that we have access to not just one leading-edge investment analyst like Michael, but a whole slate of investing minds across the StreetAuthority universe -- experts who are constantly pulling together critical insights from all over the investing world.

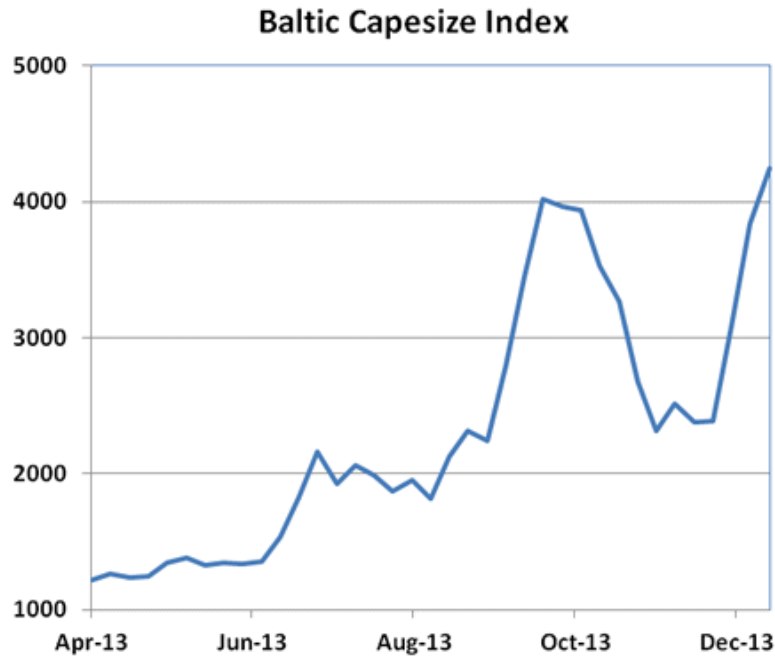
It was a recent dispatch from another of our top analysts that jogged my memory on a lesser-known way to invest in the consumer sector. One that I believe has just as much upside as today's cheap consumer goods stocks. But with much less risk of loss if the economy does happen to zig when we think it should zag.

That dispatch came in the latest edition of Amy Calistri's [The Daily Paycheck](#).

Looking for sectors with big dividend yields -- but also below-average risk profiles suitable for income investors -- Amy pointed out a very interesting chart, one I haven't seen any other analysts talking about yet.

Her chart shows how there's a boom underway in a place you might not expect: shipping.

As the chart below shows, shipping rates -- as measured by the Baltic Capesize Index -- were on a tear in the second half in 2013. And the gains have accelerated over the last several weeks.



Amy points out that the recent rise is due to growing demand for shipping of goods around the globe. Which makes perfect sense -- if demand for consumer products is indeed turning up, more goods (and the raw materials to manufacture them) are going to be sailing around the world.

Of course, increasing demand for shipping means bigger profits for shipping firms. These companies thus provide a way to profit directly from growing consumer demand -- without actually buying companies that make and sell consumer goods.

Great insight. But here's the problem. Shipping is an industry that goes against several of my rules about what makes a great business.

For example, most of the world's greatest businesses are simple and don't require massive capital investments in complicated equipment. Shipping, by contrast, is a highly logistical industry -- with big costs associated with building and maintaining cargo vessels.

The world's best businesses also have large competitive moats, a feat that's difficult to achieve in the shipping business, where nearly anyone with enough cash can buy a fleet of boats and attempt to undercut the market. It's simply a matter of setting rates cheap enough -- which firms in places like China are certainly able to do.

For all of these reasons, I'm hesitant to place a shipping firm alongside the forever stocks we currently hold in our portfolio.

But that's fine. Because I've found an even better way to invest in the transport business -- with a firm that makes big, consistent profits from one of the most elegantly simple business models I've come across.

This Month's Top 10 Stock -- Expeditors International of Washington (Nasdaq: [EXPD](#))

Expeditors International of Washington (Nasdaq: [EXPD](#)) is one of the most interesting companies going today. It's a firm that makes big-league profits from a very specialized niche -- one most investors would never think of as having the potential for the multi-billions in revenue that EXPD generates.

The company began as a single office in Seattle in 1981 focused on ocean freight.

But it quickly became much more than that when its forward-looking management came up with a novel idea: Why stop at just moving goods? Why not become the one-stop shop for

buyers and sellers looking to navigate the increasingly complex waters of global trade?

You see, at first blush you might think that trade is mainly about transporting things from one country to another. But in today's world, that's actually a lot more complicated than it sounds.

Expeditors International makes it simple by managing nearly every part of the shipping process. And here's the kicker: The firm doesn't own a single boat, truck or plane.

Unlike most big shipping firms, Expeditors works by contracting to other carrier companies. The company buys shipping space in bulk from airlines and ocean carriers -- thus obtaining very good rates.

It then employs a unique -- and very profitable -- strategy, one that's simply referred to by three letters: LCL. That stands for less-than-container load, an industry term for shipments of goods smaller than the size of an average shipping container.

Imagine you're a small or even medium-size business. You have product that has to move around the world -- fast. But you just don't have the volume that a big producer might send to China or India.

Contracting directly with an airline or ocean carrier, you would have no choice but to purchase an entire container, which would travel abroad with your half-load of goods -- and a lot of costly empty space.

But here's where Expeditors' unusual business strategy comes in. The firm purchases entire containers, then combines a number of small loads from its clients into one full container of goods, saving money by not wasting space.

This is a win-win situation. By achieving economies of scale, Expeditors can re-sell cargo space to its clients for more than it originally paid. At the same time, its clients still pay less than they would if they had to buy out a full container.

In effect, Expeditors is turning empty space into big profits.

The firm makes this easy to do -- offering a full range of services in picking up, repacking and delivering goods. It combines road, air and ocean transport for its clients -- providing greater flexibility than most of the big shipping companies are able to.

It even offers customs management services to make sure goods move quickly and efficiently through legal hoops between countries. It's a one-stop shop for cheap transport.

A Steady Income Stream From A Great Business Strategy

Expeditors' unique niche in reselling cargo space might not sound like a headline-making business. But it's proven very profitable over the years.

In 2012, the firm did just under \$6 billion in revenues. In fact, Expeditors' revenues for the past three years have been remarkably stable around that level.

The simplicity of Expeditors' business model also means good operating margins, running consistently around 30%. Since the firm doesn't own any of its own transport fleet, it avoids having to plow big sums of money back into the business to maintain equipment or buy new vessels.

This financial consistency makes Expeditors exactly the sort of company that fits with our *Top 10 Stocks* philosophy. The business is extremely enduring -- freight transport isn't going away. In fact the sector is only likely to grow as trade and manufacturing becomes increasingly globalized.

Expeditors also enjoys a big competitive moat. The company succeeds because of its decades of experience in buying and selling cargoes at the absolute best prices. A startup

competitor simply wouldn't have the expertise and contacts needed to grab market share.

And the company is working to keep its customers loyal. During the quarter ended in September, for example, Expeditors chose to absorb a temporary spike in shipping costs rather than pass the higher prices along to its customers. This leveling of costs actually increased the company's market share -- and ensured retention of existing customers.

Exactly the kinds of things I look for in our portfolio companies.

Low-Risk Upside From A Consumer Boom

As I mentioned, I believe now is an ideal time to add a company like Expeditors to our holdings because of the apparent uptick we're seeing in the consumer goods sector.

The recent outperformance of discretionary goods stocks suggests that investors see consumer spending growing over the coming months.

Such an increase in buying will be great for companies that make consumer products, but also for firms that ship them. Any growth in consumer demand would certainly benefit Expeditors -- increasing demand for the company's services as buyers and sellers trade more goods around the world.

We're already starting to see this trend in the company's results. During the most recent quarter Expeditors reported significant year-over-year growth in shipping volumes. Especially for ocean-borne shipments -- which jumped 9%.

This could well reflect growth in the discretionary consumer goods sector, a trend that would give Expeditors an ongoing boost in profits.

But here's the most important point: *Expeditors doesn't need a jump in discretionary spending to make it a great investment.*

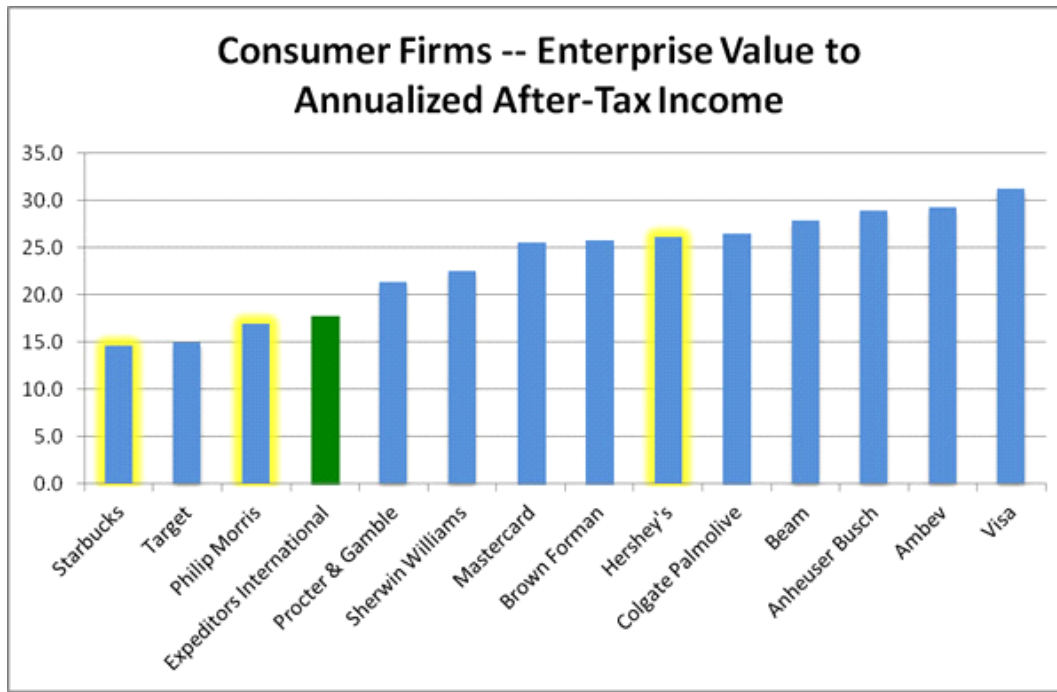
You see, producers and direct sellers of discretionary goods will live and die by what happens with the economy. If the uptick we're currently seeing turns out to be short-lived, such companies will see their profits -- and their valuations -- take a hit.

But Expeditors isn't a pure discretionary play. Even though it benefits from the discretionary market, its shipping services are equally driven by more stable sectors, like consumer staples. Whether the company ships luxury items like televisions, or basic goods like razor blades, the financial results are the same.

Thus the firm offers the upside of a discretionary company, with the downside protection of a consumer staples firm. A perfect scenario.

Best of all, today we can buy Expeditors at one of the lowest valuations across the consumer goods sector.

The chart below shows a universe of consumer stocks -- plotting current trading multiples to after-tax income. As you can see, Expeditors trades at the low end of the spectrum. (By way of comparison, I've highlighted in yellow the companies we currently hold in the *Top 10 Stocks* portfolio.)



Today, Expeditors' trading multiple of just under 18 puts it in line with discretionary consumers stocks such as Starbucks and Target (NYSE: [TGT](#)). These are the kind of firms Michael's research flags as having excellent potential for gains.

Consumer staples firms, by contrast, command much higher valuations. Firms like Colgate Palmolive, MasterCard (NYSE: [MA](#)) and Anheuser-Busch InBev (NYSE: [BUD](#)) trade at multiples of between 25 and 30 because they have a much higher perceived level of safety.

Given Expeditors' simple business model and all-weather revenues, it should trade more in line with safer consumer staples companies, a shift that would mean significant appreciation in the current share price.

I'm especially encouraged in this regard by the firm's excellent financial condition. The company currently holds \$1.4 billion in cash and short-term investments. It has no debt -- a testament to having few big expenses to necessitate borrowing.

Given all of these advantages, I expect that Expeditors will perform well if we find ourselves in a wind-in-the-sails economy -- and also if growth happens to stumble a little. I'm happy to add this excellent firm to my portfolio and see how the coming consumer boom plays out.

Risks to Consider: Rising rates for shipping globally could put a damper on Expeditors' business. However, the firm has an excellent track record in managing costs and obtaining the absolute best rates for its customers, which could mean the company might actually find more clients in a high-cost environment -- as businesses look for alternatives to help manage shipping expenses.

Action to Take --> I'll be adding 75 shares of Expeditors to my portfolio on Thursday, January 2. I'm setting my price target at \$65, where the company would command a multiple of 29 -- more in line with the consumer staples firms I see as its true peers. Of course, if growing consumer spending does boost Expeditors' profits, the upside will be even higher than that. I'll be monitoring the company's financials closely for evidence of such improving performance.

Top 10 Stocks Portfolio

My Top 10 Stocks Portfolio is designed to profit from my favorite ideas from all of

StreetAuthority's premium investment advisories. I actually buy and sell each pick in a real brokerage account, funded with \$100,000 cash. We're in this together, and I don't make money unless you make money. All prices as of the close on December 31, 2013.

Security (Symbol)	Shares	Date Added/ Purchase Price	Current Price	Current Value	Total Return	Buy Under	Target
Alcoa (NYSE: AA)	500	<u>12/5/13</u> \$9.37	\$10.63	\$5,315	+13.2%	\$10	\$15
Abbott Labs (NYSE: ABT)	213.3	<u>1/4/13</u> \$33.02	\$38.34	\$8,176	+17.8%	\$36	\$50
Automatic Data (Nasdaq: ADP)	81	<u>4/9/13</u> \$64.02	\$80.81	\$6,544	+27.5%	\$70	\$85
Brookfield Infr. (NYSE: BIP)	332	<u>7/5/11</u> \$26.09	\$39.25	\$13,030	+66.5%	\$39	\$47
Brookfield Renew. (NYSE: BEP)	235	<u>3/11/13</u> \$29.85	\$26.30	\$6,181	-12.0%	\$33	\$40
Cisco (Nasdaq: CSCO)	627.7	<u>Various</u> \$18.49	\$22.43	\$14,079	+26.9%	\$25	\$33
Enterprise Prod. (NYSE: EPD)	108.4	<u>3/2/12</u> \$52.40	\$66.31	\$7,191	+37.2%	\$60	\$80
High Div. Equity (NYSE: HDV)	114	<u>Various</u> \$63.09	\$70.22	\$8,006	+13.8%	\$70	\$85
Hershey's (NYSE: HSY)	55.3	<u>10/3/13</u> \$91.69	\$97.24	\$5,375	+6.4%	\$100	\$130
Intel (Nasdaq: INTC)	485.8	<u>Various</u> \$20.01	\$25.95	\$12,608	+40.0%	\$30	\$40
MPLX (NYSE: MPLX)	148.3	<u>2/11/13</u> \$35.07	\$44.58	\$6,613	+29.8%	\$42	\$54
Occidental Pet. (NYSE: OXY)	57	<u>9/16/13</u> \$89.60	\$95.10	\$5,421	+5.9%	\$100	\$130
Philip Morris (NYSE: PM)	90.1	<u>6/24/11</u> \$65.00	\$87.12	\$7,847	+50.9%	\$85	\$115
Starbucks (Nasdaq: SBUX)	132.6	<u>Various</u> \$52.66	\$78.39	\$10,398	+51.9%	\$75	\$93
Security Holdings				\$116,784			
\$ Cash Holdings				\$13,759			
Portfolio Value				\$130,543	+30.5%		
<small>"Total Returns" include capital gains <u>and</u> reinvested dividends since each position was added. "Purchase Price" doesn't include shares bought via reinvestment, but does include brokerage commissions. See a list of all closed trades here.</small>							

Portfolio Updates:

Question: What does a company do when a disruptive new product comes along -- one that threatens to undercut the entire market the firm has built itself on?

Answer: Buy it.

That's the tack Philip Morris (NYSE: [PM](#)) is taking with electronic cigarettes.

Last month, the company announced a strategic framework with its former parent firm Altria Group (NYSE: [MO](#)) to distribute Altria's e-cigarette products outside of the United States. The framework also allows for Altria to commercialize Philip Morris' reduced-risk tobacco production within America.

This is smart move for the company. E-cigarettes could well be the biggest shake-up ever in the tobacco business, so getting in on this sector ensures that Philip Morris won't be left

behind if e-cigs take off in a big way. The move should be a win-win, allowing Altria to tap the considerable distribution network Philip Morris has built overseas.

Speaking of overseas, two of my other portfolio companies announced significant geographic expansions last month: Hershey's (NYSE: [HSY](#)) in China, and Brookfield Infrastructure (NYSE: [BIP](#)) in South America.

Hershey's announced it is purchasing 80% of Shanghai Golden Monkey Food Co., one of the largest candy companies in China. The deal gives Hershey's an established line of Chinese brands, along with a portfolio of in-country manufacturing facilities and distribution channels.

This move is all about establishing a foothold in the biggest market on Earth. Golden Monkey's sales aren't huge right now. They're expected to total only \$225 million in 2013 -- not a lot compared with Hershey's \$7 billion in trailing 12-month revenue.

But Hershey's is hoping its expertise in the business can help grow Golden Monkey into something much bigger. This deal gives management the platform to run with -- and the potential is huge, given the large and growing market for consumer items in China.

Brookfield Infrastructure is also looking for growth, but in a different part of the world -- Brazil.

The firm said last month that it is acquiring an approximate 11% interest in VLI, one of the largest operators of Brazilian rail lines and ports.

Brookfield's timing on this deal is very good -- for a couple of reasons.

For one, currencies. The Brazilian real has depreciated by 20% against the U.S. dollar over the past 12 months. That makes Brazilian assets significantly cheaper for firms like Brookfield that are paying with foreign currency.

Brookfield's buy also comes as Brazil has fallen somewhat out of favor with investors. Buyers have fled Brazilian assets of late -- with exchange-traded funds (ETFs) like the Emerging Global Shares Brazil Infrastructure Fund (NYSE: [BRXX](#)) down over 20% in 2013.

But the country is still one of the biggest engines of economic growth globally, enjoying average GDP growth of 2.7% yearly over the past four years, compared with just 1% yearly on average in the United States.

Brookfield's new holdings in VLI should benefit from Brazil's continued development. The firm holds 4,000 kilometers (nearly 2,500 miles) of rail, along with three ports and five inland terminals, giving it significant exposure to activity in the mining, agriculture and steel sectors that drive the Brazilian economy.

Action to Take --> I'm maintaining my holdings and price targets for Philip Morris, Hershey's and Brookfield Infrastructure.

Q&A: Your Questions Answered

Do you have a question or comment about something you've seen in Top 10 Stocks? Do you want my opinion on a particular company? I always try to personally answer as many reader questions as I can. I will share those questions -- and answers -- that I believe are of the broadest interest to the Top 10 Stocks community. Please send your questions to me at editorial@streetauthority.com.

Q. Is there is an issue with Cisco Systems (Nasdaq: [CSCO](#)) being stagnated at the moment? The stock has been lagging for quite a while, and I am wondering if I should be increasing my position.

-- Raymond S., Durham, N.C.

A. The only "issue" with Cisco is the sector it's in: information technology.

Earlier in this issue, I showed a chart of relative valuations for various business sectors. If you look back, you'll notice that IT stocks are currently some of the most undervalued in the investing universe.

There's a reason for that. Stock buyers see this industry as cutthroat -- with startup firms moving quickly to grab market share from other players. Just look at the rapid success of Samsung mobile products, which came out of nowhere to grab a big chunk of the market from players like Apple (Nasdaq: [AAPL](#)).

Because of this frenetic competition, investors aren't rewarding IT companies with the kind of high multiples they do for steadier industries like utilities or consumer staples.

And therein lies the opportunity.

You see, not all information companies are created equal. Firms like Cisco and Intel (NYSE: [INTC](#)) hold unusually strong competitive advantages in this space -- the kind of entrenched moats that give them a unique staying power.

I'm therefore happy to buy and hold these great businesses -- which are selling at low valuations because of the problems everyone else is having in the tech sector. I believe that the value in a company like Cisco will eventually get recognized by the market.

In fact, it may already be happening.

The stock had been drifting downward over much of the past four months -- but that's changed abruptly the past few weeks, with the share price up 9.9% since December 13.

Investors are realizing that not all IT stocks are created equal. And given Cisco's current low valuation, the company has a lot of room to rise as stock buyers reappraise the enduring value in this excellent firm.

Action to Take --> I'm continuing to hold my position in Cisco and maintaining the stock on my "Buy First" list. I think the company represents one of the best value propositions on the market today.

Top 10 Stocks "Buy First" List

I hope you've enjoyed this month's issue of *Top 10 Stocks*. I'm glad you've joined me.

When new readers sign up, their first question is often: What should I buy first?

In the table below I've listed my top three "Buy First" picks based on today's environment and current share prices.

Security (Symbol)	Issue
Intel (Nasdaq: INTC)	September 2011
Cisco (Nasdaq: CSCO)	October 2013
MPLX LP (NYSE: MPLX)	February 2013

All the best,



A stylized, handwritten signature in black ink, appearing to read 'Dave Forest'.

Dave Forest
Chief Investment Strategist -- *Top 10 Stocks*
StreetAuthority.com

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