The Turnaround Letter

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TIME TO MOVE OUT OF THE COMFORT ZONE?

With so much uncertainty in the world these days (economic outlook, central bank policies, social unrest, U.S. presidential election, Brexit, China, etc.), it is not surprising that investors have flocked to stocks with long histories of steady earnings, dividends and share prices. Often found in sectors like utilities, packaged food and household goods, these "comfortable" stocks have been very popular so far this year as investors buy them either as individual stocks or through relatively new "low volatility" mutual funds and ETFs, which are gathering huge sums of new assets. As a result, the prices of many of these stocks have been bid up to levels that are hard to justify.

But what about the "uncomfortable" stocks, the ones that might be called "high volatility?" These may not have the steady histories of their more popular counterparts, often because they are in cyclical industries. Investors fret that if the United States enters a recession, these companies' fortunes could turn sharply downward. But absent a recession - which we don't expect - these kinds of stocks should produce strong returns.

Our favorites, listed below, are high-quality companies with solid balance sheets. Most are profitable, pay dividends and produce good cash flows. Valuations on a P/E (price-to-earnings) basis are almost all below the market average. Mainstream investors are a notoriously fickle bunch, and when they tire of the "comfortable" names, they could rotate into these more cyclical stocks pushing them up sharply.

ROBERT HALF INTERNATIONAL (RHI) – The world's largest professional staffing company, Robert Half has benefitted from rising demand for skilled permanent and temporary talent. The company's strong brand, broad network and increasingly diversified services menu should help it continue to grow, although it does face headwinds from technology-driven hiring practices and rising competition. Its balance sheet is virtually debt-free and carries a hefty cash balance. Healthy earnings combine with minimal capital expenditures to produce good free cash flow.

TEREX (TEX) – Terex makes aerial work platforms, construction cranes, maritime cargo cranes and other heavy machinery, and so it is sensitive to the ups-and-downs of the global economy and, to a lesser extent, the mining sector. The company is focusing on adding innovations to its product line and reducing costs to adjust to the lower current demand for cranes. After receiving acquisition offers from European crane maker Konecranes and Chinese crane company Zoomlion, it looks like Terex will sell its materials handling business to Konecranes for $820 million in cash and a 25% stake in

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"Uncomfortable" Stocks with Strong Potential

Company	Symbol	Recent Price	52 Week Range	Market Cap $ Bil.	Price/ Earnings	Dividend Yield%
Robert Half Int'l.	RHI	36.54	58.00 – 34.34	4.9	13.2x	2.4
Terex	TEX	24.14	27.11 – 13.62	2.5	17.8x	1.2
Timken	TKR	33.45	37.07 – 22.22	2.6	16.7x	3.3
Trinity Industries	TRN	23.21	30.38 – 14.94	3.2	9.9x	2.7
Winnebago	WGO	23.76	23.88 – 15.41	0.6	14.2x	1.7
XPO Logistics	XPO	29.62	47.20 – 18.04	3.2	38.9x	0.0

Konecranes. New CEO John Garrison (formerly head of Bell Helicopter) could bring a fresh approach to Terex's operations. Cash flow remains good, and the balance sheet will have little debt after the sale.

Timken (TKR) – Timken produces the high-quality roller bearings that make everything turn, from car wheels to jet engines to precision surgical tools. Having spun off its commodity steel business in 2014, Timken is expanding its geographic coverage and product offerings while also returning its ample cash flow to investors through dividends and repurchases. Despite solid growth initiatives, the company remains sensitive to sluggish industrial demand and currency headwinds. Debt net of cash is relatively modest, and Timken is producing healthy free cash flow despite tepid sales. A rebound in economic growth would likely get Timken rolling again.

Trinity Industries (TRN) – Trinity is the leading manufacturer of railroad cars, inland barges, highway guard rails and other heavy transportation equipment. Its product cycles tend to be long and cyclical, although its diversified markets tend to dampen Trinity's overall cyclicality. Recent sales have been hurt by lower orders for railcars that transport crude oil from remote shale locations in the U.S. This is being partly offset by strong demand for new towers used to produce wind-powered electricity. Corporate debt (excluding debt used to finance customer leases) is fully covered by cash. Trinity's profits are likely to remain solidly in the black for at least this year.

Winnebago Industries (WGO) – The maker of iconic motor home recreational vehicles, Winnebago has a strong reputation and leading market share that position it to benefit from even modest continued economic growth. Industry volumes remain 32% below their pre-financial-crisis peak, and so there is plenty of room for growth ahead. Its core demographic group, people aged 35-54, is growing rapidly as is its RV ownership rate. New CEO Mike Happe (formerly a senior executive at Toro) is likely to be more aggressive in pursuing value-added opportunities, including acquisitions, while maintaining capital discipline. The company has nearly $3/share in cash and no debt. Sales increased and margins expanded in the most recent quarter, suggesting there will not be a fall-off in volumes any time soon.

XPO Logistics (XPO) – This transportation and logistics company helps businesses manage and operate their supply chain, and is increasingly involved with e-commerce shipments. XPO's business has been growing with the rising demand for sophisticated solutions even though it still generally tracks broad economic activity. Led by Chairman/CEO Brad Jacobs, a successful businessman who bought a $150 million personal stake in the company in 2011, XPO continues to evolve toward a well-integrated, technology-driven company. Previously unprofitable, which distorts the P/E ratio, its earnings outlook is strong over the next few years. While leverage is high from earlier acquisitions, XPO could deliver impressive share gains for patient investors.

EUROPEAN BANKS—NOT DEAD YET

Part of our approach at *The Turnaround Letter* is to highlight segments of the market that are strongly out-of-favor. While not without risks, for more intrepid long-term investors willing to look where others fear to tread, these companies can offer tremendous return potential. One such segment now is European banks.

As a group, concerns about European banks are legitimate: Capital is in short supply, lending profits are narrow due to the negative interest rates, banking and trading fee income is subdued by regulations, tough markets and competition, and costs are too high. The Brexit vote (Britain's vote to exit the European Union) has investors fearing that more extreme adversity, combined with higher cross-border costs, could lead to bank failures that leave investors empty-handed.

While these concerns are legitimate, investors often overreact and push stocks down further than is justified by the risks involved. This seems to be particularly true in recent years for banks and financial institutions because of the bad memories that many investors still harbor about this sector from the 2008 financial crisis. When investors get more comfortable with these stocks again, they rebound sharply. For example, Barclays stock fell below 5 early in 2009 before rebounding to 22.50 in September of that year. Similarly, when investors became concerned about the banks again in mid-2011, Barclays stock fell to 7.75 in September and bounced back to almost 19 less than 18 months later.

Moreover, several European banks are beginning to overcome these challenges with stronger capital levels, lower operating risks, improved credit quality and tighter cost structures. And they have substantial franchises, so that they are not likely to go away anytime soon. Also, several of them pay very generous dividends, although it should be noted that the dividends of European companies tend to be more variable than in the U.S. (and in some circumstances may be subject to tax withholding). With valuations well into the bargain range, these banks look particularly interesting to us:

BARCLAYS (BCS) – Under new CEO Les Staley, who previously was a top officer at JPMorgan, U.K.-based Barclays is working aggressively to cut costs and improve profits. Plans to sell operations in Africa, France, Italy and Asia will help its long-term outlook by reducing non-core assets by 60%. Relatively strong results in its large credit card business help offset weakness in its retail and investment banking operations. Capital of 11.3% is reasonable, but the bank may need to raise new equity in the next year.

BNP PARIBAS (BNPQY) – France-based BNP is working diligently to reduce costs and shrink its asset base. This year it plans to launch an initial public offering of its First Hawaiian Bank subsidiary, likely worth as much as $4 billion, potentially generating over $1 billion in cash. Also possibly on the block: its Banc West franchise in the western United States. Elsewhere, BNP is struggling to overcome its heavy reliance on commercial and investment banking operations and high exposure to weak Italian credits. While on the low end of peers, its capital ratio of 10.9% will likely increase over time.

CREDIT SUISSE (CS) – The Swiss-based bank still has a lot of work ahead, but under CEO Tidjane Thiam, who took over a year ago, Credit Suisse appears to be making progress. The bank has been sharply cutting back its trading business, most recently in fixed income, and focusing on wealth management where it has an enviable global franchise. The latest quarterly results showed progress, but the bank is not out of the woods yet.

European Banks with Good Franchises And Low Stock Prices

COMPANY	SYMBOL	RECENT PRICE	52 –WEEK RANGE	MARKET CAP $ BIL.	PRICE/TANGIBLE BOOK VALUE	DIVIDEND YIELD%
Barclays	BCS	8.24	18.05 – 6.76	33.5	0.53	10.2
BNP Paribas	BNPQY	24.78	33.29 – 19.46	59.7	0.72	5.5
Credit Suisse	CS	11.56	29.92 – 10.01	22.4	0.57	6.2
Lloyds Bank	LYG	2.86	5.39 – 2.47	53.2	0.97	5.8
Royal Bank of Scotland	RBS	5.10	11.05 – 3.91	29.4	0.55	0.0
UBS	UBS	13.78	21.64 – 11.93	52.3	1.06	0.0

LLOYDS BANK (LYG) – Based in the United Kingdom, Lloyds' business is almost exclusively domestic. Its banking franchise is strong, and capital levels are healthy enough (at 13%) that it can continue to pay its dividends without much difficulty. Many of its prior legal issues have been addressed. While industry headwinds continue, Lloyds looks like a long-term bargain.

ROYAL BANK OF SCOTLAND (RBS) – With the U.K. representing about 70% of its business, the bank has worked to reduce its unsecured lending in recent years. Its franchise is strong across a diversified range of operations – in addition to retail and corporate banking it has capital markets, insurance, leasing and private banking businesses. Management and disclosure are considered strong. Capital is healthy at a high 14.5%. RBS faces many of the same headwinds as other banks, along with the chance of another Scottish referendum to leave the U.K, but all-in it looks like another long-term bargain.

UBS (UBS) – With a strong franchise in wealth management (nearly half of profits), high-quality management and an impressive 14.0% capital ratio, Switzerland-based UBS is relatively well-positioned to survive. Its $2 billion cost reduction program is underway, and management is emphasizing quality and profits over growth. While the bank faces pressures on its investment banking side, and the strong Swiss franc is hurting the country's economic growth, UBS is very likely a long-term banking winner.

NUMBER OF PUBLIC COMPANIES SHRINKING?

When recently asked how many companies are in the Wilshire 5000, we naturally answered, "Five thousand." However, on looking into it further, we were surprised to learn that there are only 3,607 companies in the index, which includes all U.S.-headquartered equities with readily available prices. Moreover, this is down from 7,562 companies in the index in 1998. Meanwhile, the number of listed companies outside the United States increased to 39,400 from 30,700 in 1996. What is going on here in the U.S.?

The unusually large number of mergers since 1996 is one cause of the drop-off, according to a 2015 report by the National Bureau of Economic Research*. Going private, like Dell's $25 billion deal in 2013, which will soon take EMC with it, is another major reason. Another contributor: failing to meet listing standards.

The recent surge in energy company bankruptcies will boost delistings even further.

On top of all that, fewer companies are going public. There isn't a shortage of new companies in the economy – this number actually continues to increase. Rather, there doesn't seem to be much incentive to go public these days. Promising young companies can get plenty of private funding, and technology-based businesses may need less capital than old-line manufacturers or bricks and mortar retailers. Furthermore, volatile stock markets and increases in shareholder and regulatory demands are driving companies away from the public market.

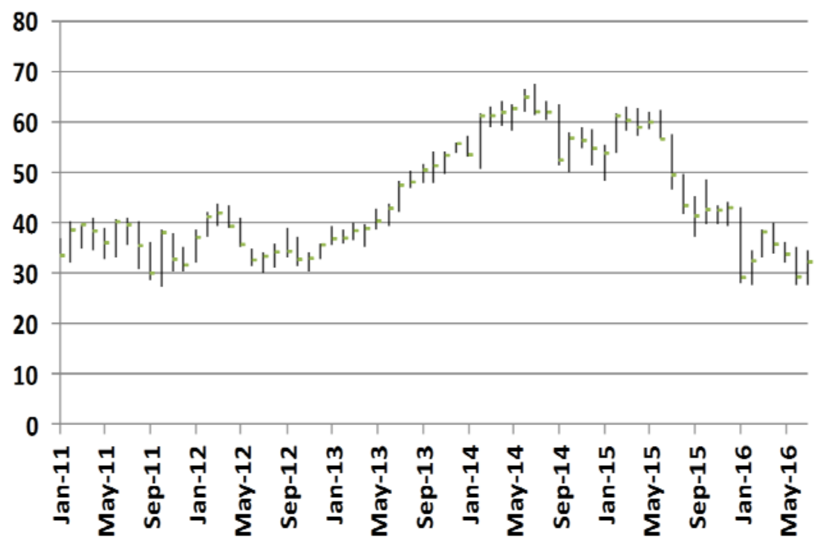
These trends seem likely to continue. What is less clear is their impact. Do valuations increase for the remaining public companies as the supply diminishes? Will individual investors have less access to the best new companies? What will happen when interest rates rise and close off the spigot of cheap money driving private deals? One thing is certain: The shrinking list of Wilshire companies gives readers a sure-win trivia question to ask their friends.

* *The U.S. Listing Gap*, NBER Working Paper 21181 by Doidge, Karolyi and Stutz, 2015.

RECOMMENDATIONS
Purchase Recommendation: BorgWarner, Inc.

BORGWARNER, INC.
3850 HAMLIN ROAD
AUBURN HILLS, MICHIGAN 48326
TEL. 248-754-9200
www.borgwarner.com

CATEGORY: MID CAP ($7.4 BIL.)
SYMBOL: BWA EXCHANGE: NYSE
BUSINESS: AUTOMOBILE COMPONENTS
ANNUAL REVENUE: $8.0 BIL. (12/31/15)
EARNINGS: $609.7 MIL (2015)
7/29/16 PRICE: $33.18
12-MONTH RANGE: $52.48-$27.52
EST. DIVIDEND YIELD: 1.6%



Background: BorgWarner supplies major automobile makers with engine and power train systems, including turbochargers, ignition and cooling systems and all-wheel-drive technologies. Formed in 1928 from the combination of several component makers, the company is widely recognized as a well-managed, high-quality industry leader. It has strong market positions in product categories that are critical to improving engine power and efficiency.

Turbochargers are the largest segment at about 31% of sales. BorgWarner's global customer base includes nearly every major car maker and is widely diversified with Ford and GM combined representing only about 20% of revenues.

While BorgWarner has produced healthy sales and earnings growth over the past five years, its stock price has gone nowhere. Growing recognition of the value of its technologies, combined with the industry upcycle, has boosted sales by 41% and profits by 62% since 2010 – and both are more than 50% higher than their pre-crisis 2007 levels. Investors, however, are concerned about a laundry list of issues: potential recession in Europe (~50% of sales), demand in China, a significant recent acquisition, ongoing dollar strength and the uncertain outlook for 15% customer Volkswagen. Falling short of revenue expectations for several quarters last year and providing subdued guidance for the rest of 2016 has also worried short-term investors.

Analysis: *The Turnaround Letter's* usual approach is to identify companies that are out of favor but are undergoing a turnaround. BorgWarner is a company that doesn't need a turnaround but is valued as if it does. Its shares are among the cheapest in the market. We find it remarkable that a company with this degree of proprietary leadership in critical automotive segments, with solid financials and growing revenue, sells at only 10.4x this year's earnings and 6.2x this year's cash flow.

The company has a relatively low level of debt, will likely produce over $400 million of free cash flow this year and is growing its organic revenues at a 4% annual rate. BorgWarner's culture positions it to continue to innovate in leading-edge technologies where competition is thin. For example, it is beginning to win important contracts for hybrid/electric vehicles. We think the wheels will keep rolling with this high-quality company, and when investors recognize that, the stock price should move up nicely.

We recommend buying shares of BorgWarner up to 52.

Sale Recommendation: Sony Corp.

Sony's stock has performed well for much of 2016 led by strength in its gaming business. However, we are becoming concerned about the drivers for continued appreciation. Sony has a lot of moving parts, and many of them are in highly competitive sectors. We recommend taking profits now.

NEWS NOTES & UPDATES

MGIC Investment Corporation continues to show improving results. Reserves are still coming down, and it is doing well at writing new mortgage insurance business. We are making it a "buy" again, up to 10. It is also worth taking a look at MGIC's competitor **Radian**, as well as another one of our recommended stocks, **Old Republic.** Many investors seem to be treating the mortgage insurance sector as though we are headed for a repeat of the 2008 housing crisis. Our view is the opposite – housing is likely to remain strong for some time to come.

Disclosure Note: Accounts managed by an affiliate of the Publisher own MGIC and Radian securities.

Tribune Publishing has changed its name to **tronc** and its stock symbol to TRNC. The company now appears to be negotiating with Gannett about a sale price. Meanwhile the stock has inched up to around 15. We still expect tronc to reach a deal with Gannett at a higher price, but we wouldn't chase the stock here, and so we are making it a "hold."

Disclosure Note: Accounts managed by an affiliate of the Publisher own tronc stock.

PERFORMANCE

The tables below and on the next page show the performance of all of our currently active recommendations, plus recently closed out recommendations. The categories are based on market capitalization on the recommendation date, except that recommendations made prior to August 2004 are categorized by their 8/20/04 market cap.

SMALL CAP (under $1 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	7/29/16 PRICE	TOTAL % RETURN (3)	CURRENT STATUS (2)
Bristow Group	BRS/NY	Nov 86	0.75	10.88	+1817	Hold
ACCO Brands	ACCO/NY	Mar 10	7.17	11.16	+56	Buy (12)
Fairpoint Communications	FRP/NQ	July 11	9.42	15.88	+69	Hold
Stewart Information Services Corp.	STC/NY	June 13	29.34	43.86	+55	Buy (45)
Accuride Corporation	ACW/NY	Oct 13	5.14	1.31	-75	Buy (8)
Layne Christensen Co.	LAYN/NQ	Nov 13	19.59	8.02	-59	Buy (12)
Ply Gem Holdings, Inc.	PGEM/NY	Apr 14	12.63	15.64	+24	Buy (20)
M/I Homes, Inc.	MHO/NY	Aug 14	20.67	23.01	+11	Buy (27)
tronc	TRNC/NY	Dec 14	21.09	14.99	-26	Hold
McDermott International	MDR/NY	Apr 15	3.73	5.12	+37	Buy (7)
Star Bulk Carriers Corp.	SBLK/NQ	Aug 15	15.50	4.00	-74	Buy (5)
NII Holdings, Inc.	NIHD/NQ	Nov 15	7.00	2.96	-58	Buy (11)
Arctic Cat, Inc.	ACAT/NQ	Dec 15	22.26	18.27	-18	Buy (30)

MID CAP ($1 billion - $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	7/29/16 PRICE	TOTAL % RETURN (3)	CURRENT STATUS (2)
Janus Capital Group	JNS/NY	Aug 05	15.27	15.10	+13	Buy (21)
Old Republic	ORI/NY	June 08	14.64	19.38	+74	Buy (21)
MGIC	MTG/NY	Jan 11	10.11	7.19	-29	Buy (10)
Cypress Semiconductor	CY/NQ	Jan 13	10.63	11.64	+21	Buy (16)
New York Times	NYT/NY	Mar 13	9.64	12.98	+40	Hold
PennyMac Mortgage Investment Trust	PMT/NY	Sept 13	21.40	16.23	+7	Buy (26)
Allscripts Healthcare Solutions	MDRX/NQ	Feb 14	16.43	14.12	-14	Buy (24)
Oaktree Capital Group, LLC	OAK/NY	Oct 14	51.23	46.42	-2	Buy (63)
Globalstar, Inc.	GSAT/NY	Nov 14	2.16	1.19	-45	Buy (4)
FTI Consulting	FCN/NY	Feb 15	40.24	42.84	+6	Buy (50)
Mattel, Inc.	MAT/NQ	May 15	28.43	33.38	+24	Buy (38)
Chesapeake Energy Corp.	CHK/NY	June 15	14.11	5.42	-62	Hold
Extended Stay America	STAY/NY	Feb 16	12.79	14.16	+14	Buy (20)
SeaWorld Entertainment	SEAS/NY	Apr 16	21.45	15.40	-27	Buy (27)
Crocs, Inc.	CROX/NQ	May 16	8.35	11.33	+36	Buy (13)

KEY: (1) Exchanges: NY= New York; NQ= NASDAQ; OTC = OTC Market
(2) Maximum recommended buy prices in parentheses; (3) Total return includes dividends as well as price changes.

LARGE CAP (over $10 billion) CURRENT RECOMMENDATIONS

RECOMMENDATION	SYMBOL/ EXCHANGE (1)	REC. ISSUE	PRICE AT REC.	7/29/16 PRICE	TOTAL % RETURN (3)	CURRENT STATUS (2)
Ford	F/NY	Dec 03	13.00	12.66	+17	Buy (20)
General Electric	GE/NY	July 07	38.12	31.14	0	Buy (37)
Motorola Solutions	MSI/NY	Aug 07	68.52	69.38	+11	Buy (75)
Bank of America	BAC/NY	Oct 08	35.00	14.49	-56	Buy (20)
Fifth Third	FITB/NQ	Nov 10	12.56	18.98	+66	Buy (25)
General Motors	GM/NY	May 11	32.09	31.54	+8	Buy (45)
Xerox	XRX/NY	Aug 11	9.58	10.30	+17	Buy (17)
Sony	SNE/NY	Sept 11	22.01	33.41	+52	Sell
Weyerhaeuser Co.	WY/NY	Apr 12	21.89	32.72	+59	Buy (35)
BP plc	BP/NY	July 13	41.78	34.40	-1	Buy (55)
Freeport-McMoRan Copper & Gold	FCX/NY	Aug 13	28.21	12.96	-46	Buy (15)
EMC Corporation	EMC/NY	Dec 13	23.72	28.28	+22	Hold
Citigroup, Inc.	C/NY	May 14	48.16	43.81	-8	Buy (65)
Ally Financial, Inc.	ALLY/NY	Sept 14	24.95	18.04	-27	Buy (33)
Royal Dutch Shell plc	RDS-B/NY	Jan 15	69.95	54.21	-14	Buy (85)
Nokia Corporation	NOK/NY	Mar 15	8.02	5.77	-22	Buy (12)
Caterpillar, Inc.	CAT/NY	July 15	85.30	82.76	+2	Buy (100)
The Mosaic Company	MOS/NY	Sept 15	40.55	27.00	-31	Buy (50)
Rio Tinto plc	RIO/NY	Jan 16	29.09	32.82	+17	Buy (36)
Rolls-Royce Holding plc	RYCEY/NQ	Mar 16	9.25	10.90	+19	Buy (14)
First Data Corporation	FDC/NY	June 16	12.53	12.40	-1	Buy (16)
Macy's, Inc.	M/NY	July 16	33.61	35.83	+7	Buy (48)

RECENTLY CLOSED OUT RECOMMENDATIONS (ALL CATEGORIES)

RECOMMENDATION	SYMBOL	REC. CAT.	BUY ISSUE	PRICE AT BUY	SELL ISSUE	PRICE AT SELL	TOTAL % RETURN (3)
Carnival Corporation	CCL	Large	Jan 01	30.50	July 15	48.95	+98
MetLife	MET	Large	Feb 13	37.20	Aug 15	57.21	+62
Kemet	KEM	Small	Feb 11	14.75	Oct 15	1.73	-88
Avon Products	AVP	Mid	July 14	14.60	Oct 15	3.25	-76
Interpublic Group	IPG	Mid	Dec 06	11.94	Nov 15	22.71	+103
Johnson & Johnson	JNJ	Large	Jan 12	65.45	Dec 15	101.24	+70
Dow Chemical Co.	DOW	Large	Jan 14	44.60	Jan 16	51.66	+22
Drew Industries	DW	Small	Mar 11	23.13	Apr 16	64.40	+204
Federal-Mogul	FDML	Mid	May 08	21.00	Apr 16	9.84	-53
The Fresh Market	TFM	Mid	Oct 15	22.94	Apr 16	28.52	+24
Superior Industries	SUP	Small	Sept 10	14.75	June 16	27.14	+104
Coca-Cola	KO	Large	Apr 11	32.86	July 16	45.33	+59

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