Alley Company Quarterly Letter
Blue Chips

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Definition: Stock of a large, well-established and financially sound company that has operated for many years. A blue-chip stock typically has a market capitalization in the billions, is generally the market leader in its sector, and is more often than not a household name. While not a necessity, most blue-chips have a record of paying stable or rising dividends for years if not decades.[1]

This definition is a compelling enticement to invest in blue-chip stocks. We would add to this definition a requirement for predictability and sustainability in a company's revenue and earnings growth, and that the business possesses a wide moat (barriers to entry) to help thwart competitive threats.

In the aftermath of the Great Recession and the accompanying bear market, Wall Street brokerage firms and trust banks have been busy selling "risk aversion" to investors and in doing so have created overly diversified and complex portfolios that supposedly control risk without diluting returns. Some have labeled this practice a "chocolate mess." Investing need not be complex; in fact, simplicity and understandability are desirable traits in an investment program.

Building a portfolio of blue-chip stocks with a strong dividend paying component as the centerpiece of one's equity allocation and using low-cost ETFs (exchange-traded funds) to gain access to other asset classes if desired, can provide the appropriate level of diversification in an asset allocation framework. The table below illustrates that large-cap U. S. stocks (of which blue-chips are a part) have generated the best returns when measured against risk as depicted by the Sharpe Ratio over the past 88 years.

Return vs. Risk

	88-Year Period Ending 12/31/13		
Asset Class	**Annualized Return**	**Standard Deviation**	**Sharpe Ratio**
U.S. Large Capitalization Equities	10.1%	20.2%	.327
U.S. Small Capitalization Equities	12.3%	32.3%	.272
U.S. Long-Term Gov't Bonds	5.5%	9.8%	.204
30-Day Treasury Bills	3.5%	3.1%	n/a
Inflation (CPI)	3.0%	n/a	n/a

Source: Morningstar

[1] www.investopedia.com, Blue-Chip Stock definition.

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Time is the Friend of the Wonderful Business

An analysis of the total return potential of a "blue-chip" like Procter and Gamble (PG) is a good example of high understandability and the type of investment we like to make. PG is the market leader in branded consumer products worldwide. They make *Crest* toothpaste, *Pampers* diapers, *Gillette* razors, *Tide* laundry detergent, and many more #1 brands that consumers "use up every day." Showcasing its financial strength, Procter has raised its dividend an average of 10% per year for the past 30 years and has raised its dividend for 58 consecutive years, amazing feats in our judgment. Currently the dividend yield on PG stock is approximately 3%. We estimate that PG can grow its annual earnings 6-7% over the next ten years. Over long periods of time, say 5-10 years, stocks tend to track the rate of earnings growth in the underlying company. If PG grows its earnings 6-7% per year over time, an investor can hypothetically expect a 9-10% total return annually when considering the 3% up front dividend yield plus the 6-7% earnings growth. The prospect of compounding money at a rate of 9-10% in a blue-chip company like Procter and Gamble is a very attractive risk/reward proposition. This annual return expectation is not linear in nature and will ebb and flow with the fluctuations of the stock market, but as Warren Buffet suggests, "time is the friend of the wonderful business."

Understanding what you own is a key tenet in investing and one that we strongly embrace. Owning a portfolio of large, well-established, and financially sound companies with a record of paying stable or rising dividends for years if not decades – called "blue-chips" – as the centerpiece of an investment program, makes a lot of sense to us in the quest for generating solid risk-adjusted returns.

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