

# SOUND ADVICE

Volume XX, Number 4

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April 13, 2007

## Let Them Eat Computers!

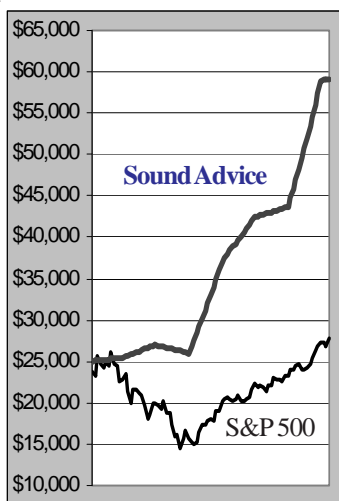
Marie Antoinette, King Louis XVI's cupcake, lost her head to the guillotine during the French Revolution. She supposedly said during an earlier upheaval as Parisian crowds rioted over the price of bread, "If they have no bread, let them eat cake." She'd be quite comfortable with the Consumer Price Index's methodology that neutralizes rising costs for necessities such as food, energy, and healthcare by fabricating deflation in other sectors. Thus, as far as the CPI is concerned even if it still costs \$1000 to buy a desktop computer, it would "fall" in price if this year it came with another 10 gigabytes of hard drive capacity or a faster processor. Hence, if your grocery bill seems a tad high, why not do your food shopping at CompUSA? So what if you have to put gas in the tank and dinner on the table every day? That every five-year computer purchase is "dropping" in price.

We've beaten on this subject for years, complaining that the figures Washington and Wall Street relied on to soothe concerns over inflation are misleading, perhaps even deceptive. There are just too many confluent basic costs that are rising to let anyone deny categorically that inflation is non-existent. Indeed, Mr. Bernanke's comments to congress last month clarified the Fed's position: inflation remains the primary concern—not what Wall Street wants to hear.

### ***NO INFLATION FOR INTEREST RATES—TILL NOW***

The usual response to inflation anxiety has been to point to interest rates, which have not acted as if inflation were on the horizon. In fact, since last summer the yield curve, the difference between shorter and longer maturity Treasury debt when presented in chart form, has been negative, that is, longer-term rates were lower than shorter-term rates, which violates a basic rule for bond investing: the risk premium should be higher for longer-duration debt, since longer duration means longer exposure to risk. Effectively, lenders signal through the inverted yield curve that they anticipate interest rates in the future will fall, usually because the economy is expected to slow and/or fall into recession. Indeed, economists consider an inverted yield curve a harbinger of recession.

But last month, the yield curve uninverted itself, as the 10-Year Note's yield bobbed up to 4.60% while the 2-Year Note yield stood at 4.57%. Perhaps the yield curve is now denying the possibility of a recession, or, perhaps anxiety over inflation trumps concerns about economic slowing. A slow economy and inflation normally mingle as well as oil and water, but it can happen, and we do have a word for it: "stagflation." We'll see.



Since 1-1-2000

## Performance History: Sound Advice versus the S&P 500

An Investment of \$25,000 becomes:

Start Date	S&P 500		Sound Advice*		
	Annual Return	Annual Return	Annual Return	Advantage Over S&P	
From 1/1/2006	14.5%	\$29,646	27.3%	\$4,154	
From 1/1/2003	14.4%	\$44,406	21.3%	\$12,392	
From 1/1/2000	1.0%	\$27,712	12.6%	\$31,424	

\* These returns are calculated assuming an equal amount is invested in all *Sound Advice* Model portfolio positions at the time of the initial recommendation.

# Inflation in the Shadows

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## *WIDEN YOUR HORIZONS*

While the Fed was raising rates, other central banks, especially Asian central banks, weren't in step. Globalization is not just outsourcing manufacturing to China, it also is the global flow of cheap credit from Japan, from China, and elsewhere to voracious borrowers, chief being us. Cheap foreign lenders have fueled any number of U.S. markets: the trillions funneled into private equity deals come from all around the globe. A generation ago, we called these deals "LBOs," (leveraged buy outs), which at least reminded us that borrowing (leverage) underpinned them. "Private equity" sounds much more discrete, much more dependable than playing the game with someone else's money. Blackstone Group, a premier private equity house, last month announced it would do an IPO, which either is wonderfully generous of them, or could mark what they believe represents the best moment to sell their sizzle to suckers, that is, you and me.

The real estate party, also financed by cheap credit, got an extra push from relaxed, perhaps even stupid, lending "guidelines" that brought us no-down-payment, interest-only, adjustable mortgages, many extended to borrowers who were not required to verify their incomes or were marginally capable of servicing their debt at the time the mortgages were signed. Risk seemed to be the furthest thing from anyone's mind. It was unpatriotic not to be a buyer.

Some are now asking as subprime lenders get vaporized, where were the regulators? Why wasn't something done to prevent just such a meltdown? Well, the regulators' mentality might have been summed up and certainly influenced by Alan Greenspan, who helped make interest rates so seductive between July 2000, when Fed Fund rates were at their zenith (6.5%) and July 2004 at their nadir (1%) that he provided the fuel for all credit-driven bubbles. Just five months before his Fed started raising rates in 2004, Greenspan helpfully encouraged lenders to come up with new, creative adjustable-rate mortgages, since he felt that fixed-rate loans cost too much for the insurance they offered against rising interest rates. What could he have been thinking or drinking? It's as if an arsonist stood outside a building he intended to torch the next day and explained why fire insurance cost too much.

In fact, the Maestro got even loopier about lending. Eight months later, he encouraged a meeting of community bankers that all was well in real estate, and congratulated them for "reach[ing] out to households with previously unrecognized borrowing capacities," thanks to "improvements in lending practices driven by information technology" a notion he returned to in April 2005

when rates were rising but the housing bubble was still full: "lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers...Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately." Well, two years later, Mr. Greenspan's faith in the integrity of the subprime market turns out to have been misplaced and mispriced. But Wall Street loved those subprimes, which could be repackaged and sold to investors hungry for yield. Those subprime mortgages when bundled together could be rated for risk, and then sliced up to provide various yields that reflected different risk levels. At the conservative end you accepted a modest yield that depended simply on return of principal, while at the other end you grasped a very high yield that depended on the least creditworthy's borrowers' ability to maintain principal and interest payments. Wall Street used every part of that pig—but first put some lipstick on it.

## *HOW CONTAINED IS THE SUBPRIME FIASCO?*

The collapse of the subprime lenders is the canary in the coalmine. We got winged when Friedman, Billings, Ramsey, which had exposure to the mortgage market, tumbled. Most observers assert that the subprime debacle is a contained event that will impact neither the more creditworthy mortgage market nor the rest of the economy. We're not so sure. In the Alt-A market, the next level up from subprime, there already is trouble, and for prime adjustables, problems are emerging as rates get reset to reflect higher benchmarks. As for the rest of the economy, it's too early to tell, but Doug Kass, a bear we mentioned last month, points out that Harley-Davidson, which like the mortgage lenders had large exposure to subprime customers, has seen its 30-day delinquency rate on loans march steadily upwards since mid-2006. Harley has increased its reserves to cover the problem. The question is whether and when other consumer sectors will start to feel the heat.

## *WHAT TO DO?*

Mr. Bernanke, who inherited the consequences of Alan Greenspan's stimulative credit policies, late last month shook up Wall Street when noting that his "predominant policy concern remains the risk that inflation will fail to moderate as expected." This came after Wall Street the week before had interpreted the most recent Federal Reserve statement to mean that inflation was not a threat,

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Circuit City just fired 3400 employees or 8% of its workforce to cut costs. Relentless price competition for the hottest items, especially flat-panel TVs, slashed margins, so management is tightening the corporate belt. The layoffs target neither the poorest performing stores nor the poorest performing employees. Instead, CC fired all of its better-compensated hourly workers, because management says that the productivity differential between what fired workers earned and what their cheaper replacements will be paid isn't enough to justify retaining the more experienced workers. We consumers too focus almost exclusively on cost. If Wal-Mart has that plasma TV at a lower price, we show no loyalty to CC. By reducing employees to a commodity ultimately valued only by the ratio of cost to productivity, and thus ignoring an implicit compact between boss and worker that loyal employees are more than machines to be replaced should a cheaper model be available, Circuit City succumbs to a vicious instinct that places immediate profits over longer-term stability. But CC is not entirely ruthless. For example, consider how the company treats one employee, Phil Schoonover, who last year pocketed \$2 million in salary and bonus, and \$3.3 million in restricted stock awards, despite that during his 2006 season as CEO, Circuit City's share price went from \$22.65 to \$18.98, and some observers think CC is using smoke and mirrors to hide even worse performance. I'm sure there's someone just as qualified as Phil to run Circuit City who'd be willing to work for less. But CC is sticking with Phil. Now that's loyalty.

--Gray Emerson Cardiff

## Holding It All Together

If you're like me, you've found yourself trying to build or repair something at home, and after investing more time than you anticipated, find yourself frustrated because you don't have the right screw to finish the job. It's off to the hardware store to spend even more time trying to guess which package contains what you need. Then you get home, and discover you still don't have the right screw. In the end, you spend an hour getting to the point that requires that screw, another hour locating the right screw, and five seconds putting it in place. All the while, you are thinking: I'd pay anything for that right screw, which really means that you'd happily have paid at the start of your quest a quarter for the right screw rather than the nickel per screw you eventually paid. On that nugget of universal experience **Fastenal (FAST—Nasdaq)** has built a very, very profitable business except they don't cater to do-it-yourselfers like you and me. They leave those customers to Home Depot. Instead, Fastenal is the go-to guy for the construction trades, small to medium manufacturers, and repair services, all of which are happy to pay premium prices to get the least expensive part of whatever they do at the moment they need it.

Fastenal has been a remarkably successful company both in terms of profitability and share price appreciation. Starting with a single store in Winona, Minnesota in 1967, Fastenal went public in 1987, and today operates more than 2000 locations almost exclusively in North America. Management, which characterizes itself as a bunch of "non-flashy Midwesterners," runs this \$1.8 billion in sales company as simply as that first store was run. In fact, Fastenal, now a \$5.4 billion market cap company, never left Winona, a town of fewer than 29,000 residents, perched on the Mississippi River in Minnesota's southeast corner.

Unlike many companies *Sound Advice* recommends, Fastenal has not experienced freefall or a severe corporate setback, but the shares have taken a hit. Though valuations are relatively attractive, they are

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## Sound Advice on Fastenal

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definitely not rock bottom. Over the last year, as investors worry about a slowing economy and the end of the housing boom, the share price is down 28% from its May 2006 all-time high, yet the company today appears just as robust as when the share price was hit its zenith. What we have here is a chance to fasten on to a remarkable company at a very good price.

### **HOW TO GROW A BUSINESS**

Fastenal got from that first store in Winona to its 2000<sup>th</sup> in Seattle by following a fairly simple formula that it has tweaked as the company expanded: locate stores in small to medium-sized metropolitan areas with populations between 25,000 and 100,000. Place the stores in relatively out-of-the-way areas where rents are cheap. Put your money into inventory and delivery rather than shiny shelving and eye-catching displays. Keep the employee headcount skinny. Don't spend much time on sweet talking Wall Street. Spend nothing on advertising. Make distribution and logistics core competencies.

Over time, Fastenal has expanded into major population areas like Seattle, and has developed a system of hub distribution centers scattered strategically around the country. Even in major metropolitan regions

the company sets its barebones stores in the same low-rent locations: light industrial parks or strip malls away from commercial districts. Fastenal has been remarkably successful in its expansion. New stores on average are profitable within 10 to 12 months. During the company's 40-year history, only 10 have had to be closed. (three of those were re-opened). Management believes that North America (U.S., Canada, Mexico) can absorb 3500 stores, and aims to increase that count by mid-teen percentages. In 2005, that number rose by 222 (14.5%); last year, it rose by 245 stores (14%). At this rate, Fastenal will hit 3500 stores in early 2011, which leaves skeptics to wonder what Fastenal can do to maintain its remarkable growth pattern?

One strategy that has been working since the mid-1990s is to add new product lines to the core fastener business. During the first three quarters in the 2007 fiscal year, the company derived 51.7% of sales from its traditional lines of fasteners and 48.3% from new products that include tools (10.9% of sales for 2006), cutting tools and abrasives (4.8%), hydraulics and pneumatics (6.2%), janitorial supplies (5.3%), electrical supplies (3.7%), welding supplies (3.5%), safety supplies (5.4%), and metals (0.6%). None of these generates the same fat margins as do

fasteners, but they contribute nicely to Fastenal as a single-stop destination for its customers. Nonetheless, Fastenal enjoys 50%+ gross margins, and brings much of that down to its net margins.

Fastenal does have new markets to penetrate but they are outside of North America, where it has made no significant effort to export its business. From today's almost non-existent foreign presence (two stores in the Netherlands, one in Singapore, and one in Shanghai), the field is wide open. We see nothing to suggest the Fastenal model would not travel well, but are not surprised that as with other decisions management is just as deliberate in contemplating overseas expansion as it has been with everything else.

Fastenal is still focused on North America, since even when the North American market reaches saturation, it believes there is plenty of expansion possible within that universe of 3500 locations.

### **CSP AND DISTRIBUTION**

At the same time Fastenal is expanding its store count, it is also expanding stocking at some of its existing stores under a program dubbed Customer Service Program 2 (CSP2), which feature almost double the inventory of standard stores. This allows CSP2 stores to

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meet customers' requirements locally rather than involve deliveries from either local distribution hubs or from the major hub in Indianapolis. CSP2, begun in the first quarter of 2005, at the end of last year was in place in about 200 stores, and will continue to grow.

Basic CSP Fastenal stores opened for 10 years or more, that is, the most mature locations, for the first nine months of this fiscal year increased sales by 7.8%, those opened five years or more by 9.8%, while those converted under the CSP2 initiative grew sales at a 15.8% clip, and more than tripled the rate of growth of new accounts at non CSP2 stores opened 10 years or more (14.2% vs. 4.5%) and double that rate compared to 5+ year stores. Early results suggest that over the long term the payoff will justify the costs for CSP2 formatted locations.

Fastenal is now prototyping another variation on the CSP model that increases inventory beyond the CSP2 model and adds more signage to assist customers in assembling their own orders.

Finally, in addition to its expansive chain of stores, Fastenal was a relatively early adapter of Web-based marketing in the late 1990s when it partnered with Internet Business-to-Business portals to take its marketing and sales online. Today, [www.fastenal.com](http://www.fastenal.com) provides a robust online ordering and billing system that leverages its stores as distribution points, a nice combination of the worlds of dotcom and brick-and-mortar.

The evolution of in-store inventory goes hand in hand with Fastenal's 13 distribution hubs that

are scattered around the United States and Canada. These hubs stock most of what Fastenal customers require that cannot be stored locally, and the national master hub at Indianapolis backstops the other hubs by having everything in the company catalogue.

Fastenal last year expanded the Indianapolis distribution center, and this year is investing heavily in a new California hub at Modesto that for customers west of the Rockies will function as does the Indianapolis distribution center for the rest of the country.

Regardless of how well-stocked the stores are, the key to efficiency is Fastenal's fleet of trucks. In 2006

**Fastenal's price ratios are absolutely higher than we are accustomed to seeing, but Fastenal's profit margins, return on equity and total capital are robust enough to warrant ratios commonly seen in go-go stocks.**

management worked to expand the use of its own vehicles rather than rely on independent truckers not just to reduce costs (which it did) but also to improve logistics, since delivery routes are easier to fine tune with a dedicated fleet of trucks. Fastenal can promise its customers that whatever they need will be at their local store within two days regardless of where they are, and most items are there the next day. Some portion of deliveries involve air freight.

Rising fuel prices boosted costs, of course, but Fastenal prefers to contend with that expense directly

rather than deal with trucking companies that were quick to add fuel surcharges as the price of diesel shot higher but slow to reduce them when prices softened.

### ***BALANCE SHEET***

Another reflection of Fastenal's preference for simplicity is the balance sheet. Despite pouring cash into expanding its stores and its distribution system, management has done it all with cash flow, and has no debt. There's no preferred stock, and there are no pension liabilities, since Fastenal depends on a defined contribution program. Over the last year management has tightened up its accounts receivables collections, which has helped both the balance sheet and the income statement. The company even raised the dividend, paid semiannually, to 42 cents.

### ***MARGINS AND WHAT'S BUGGING INVESTORS***

Lean operations from the senior executive suite down to the barebones stores yield margins that are closer to those at Tiffany than Home Depot. Management aims for a 50% gross margin (At Tiffany, the gross margin is 60%. At Home Depot it's 33%.). Last year, Fastenal's gross margin was 52%, which translated into a 19.5% operating margin, and an 11% net margin on \$1.8 billion in sales.

However, over the last few quarters margins have been under pressure and sales growth fell slightly short of expectations, a source of concern for investors that

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was front and center during January's conference call.

Fastenal as its share price mounted has come to be seen as a growth stock, and labors under the same pressures as does any growth-oriented company, so when sales even hint at slowing, a significant portion of its shareholders can't get out the door quickly enough. The 28% price drop since 2006 reflects that skittishness.

Management in its conference call had to explain why sales, which grew at a 16.8% rate for the previous quarter, had been outpaced by operating and administrative expenses and why inventory growth had outpaced sales growth.

The answers were presented simply: CSP2 stores involve more employees and a greater investment in inventory. Expanding and stocking the Indianapolis major hub added \$25 million to capital expenditures. Second, at year end, Fastenal took advantage of juicy pricing from several suppliers that slashed prices in order to make their own year-end sales numbers. The deals were too good to pass up, which to us suggests a management tuned into long-term opportunities rather than short-term consequences.

Management says it does not see troubling signs in its markets. Commercial construction remains strong, though residential construction obviously is weak. Fastenal says it makes most of its building sales to commercial firms rather than residential.

Nonetheless, the stock has suffered. Among the 10 analysts who follow FAST, there are nine

Holds and single Buy. That lone analyst, at Baird, considers current valuations cheap, and believes that when the Index of Supply Management (ISM) falls below 50, as it has twice in recent months, the shares of suppliers to original equipment manufacturers and to maintenance and repair operations outperform over the next year.

On its face this argument is counterintuitive, since the ISM is a leading indicator for the economy, and when it breaks below 50 signals a slowdown. For those of us who are ready to buy straw hats in winter and companies when the business cycle has beaten their shares down, developing an interest in cyclical stocks when the economy appears to be slowing should come as second nature. The most recent ISM report (based on March 2007 figures) broke above 50 once more, and as we note in the cover story, the re-inverted yield curve might be interpreted as evidence that the economy is in better shape than some (occasionally us) believe.

### VALUATIONS

Here it gets a bit sticky for us, since we are knee-jerk deep value investors, and prefer to see valuations that are absolutely low, something that is not evident at Fastenal. The current trailing Price to Sales ratio stands at 27 compared to the average S&P 500 stock's 20. However, over the last decade, FAST has fluctuated at an average P/E of 39 at its top price and 22 at its low. Price to Cash Flow and Price to Sales also, though headier than we usually see in our recommendations, also fall

in the lower portion of Fastenal's valuation history.

Apparently the company believes the shares are worth accumulating. With investors dour about Fastenal's immediate future, the board of directors is diverting cash flow to buy shares back. In 2005, the board authorized a 760,000 share buyback and in June 2006 added 500,000 shares to that. As of the end of the third quarter, Fastenal had bought in all but 86,000 shares of the 1,260,000 already authorized at an average price of \$36.49, so in January the company authorized the purchase of another million shares. We expect FAST will keep shrinking the float.

### SUMMARY

Fastenal's price ratios are absolutely higher than we are accustomed to seeing, but Fastenal's profit margins, return on equity and total capital are robust enough to warrant ratios commonly seen in go-go stocks.

Management, which owns about 17% of the common, over the last couple of years has not rewarded itself with options, and compensation is tightly determined by performance. Earlier this year, *Morningstar* named Fastenal's CEO Will Oberton its CEO of the Year for 2006, outpointing other finalists such as John Chambers at Cisco and Ken Chenault at American Express. That honor is more than a personal accolade. Oberton, following in the footsteps of Fastenal's founder, keeps it simple even if his company sports a very rich valuation. Buy FAST up to \$39. [SA](#)

## PORTFOLIO UPDATES

Last month was a roller coaster punctuated by one huge drop, a couple of smaller but still substantial dips, and then a long rise that brought the Dow since the last letter to a 2.3% gain. The S&P was up 2.9%, and the Nasdaq 3.5%. The Sound Advice portfolio added 3% led by a mix of natural resources, media, and drug shares.

**Maxim Integrated**, the analog and mixed-circuit semiconductor company recommended last month, did not contribute, dropping 10% on tepid news about demand for semiconductors. First, Motorola said that sales were down for its cell phones, which means suppliers to Motorola such as MXIM also must be seeing slower sales. Then the Semiconductor Industry Association reinforced the Motorola message: global sales in February were down 6.5% compared to the previous month. None of this changes our perspective that semiconductor makers are suffering though a cyclical glut that crimps margins. The industry is in the doldrums, which creates an extraordinary opportunity to snare shares in a premium company at ordinary prices.

Something seems to be going on with **Tetra Tech**, the environmental remediation and water purification company, whose stock has been loitering in the mid-teens lately after a spectacular run last year. On March 28 and March 29 TTEK traded at triple its average daily volume, and added respectively 4.8% and 6.4% on zero news. Since the last letter, TTEK is up 9.8%.

**Sprint Nextel** continues to lose Nextel customers that were part of the Nextel acquisition. We believe Sprint Nextel can reverse this trend as it incorporates more bells and whistles in its service to draw new

customers content to pay for the added services, especially those related to the Internet. S is rolling out Pivot, a partnership with cable companies like Comcast, Cox, Time

annual meeting in New Orleans of the American College of Cardiology. The study concluded that for patients not experiencing a heart attack or at very high risk of having one medications

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Warner, and Advance/NewHouse, to sell a four-bundle of mobile phone, landline, cable entertainment, and Internet, in 32 more cities, and is preparing to expand the program from consumers to small businesses. But there was some bad news late last month. The Government Services Administration did not include Sprint Nextel among bidders on a contract to create a unified communications system for the federal government that has a potential price tag of \$48 billion over ten years. Since the last letter, S is up 0.7%. Regardless, at the current price we can buy Sprint and Nextel for not much more than Sprint itself is worth. Upside in the future will turn on Wimax that can supercede not just Wifi but even that last mile of wiring into homes and businesses.

### HEALTHCARE

The battle over how effective stents are in dealing with cardiovascular disease and heart attacks heated up last month when a major randomized study's results were released at the

were just as effective as stents in preventing a heart attack. The news panicked holders in Boston Scientific (BSX fell 6.6% on the news), the company that derives more of its revenues from stents than from any other product. However, BSX and other stent makers never claimed stents prevent heart attacks. Stents, they have always claimed, ameliorate conditions that cause angina, which results from clogged arteries. We think, once cardiologists and patients absorb the real significance of the New Orleans presentation, stents will continue to play a prominent part in treating cardiovascular issues.

There was some substantial news, however, about a competitor for BSX and for **Johnson & Johnson** in the drug-coated stent market. Abbot Labs expects to market in the U.S. a dissolving drug-coated stent. These stents seem to be more effective than what either BSX or JNJ markets. For BSX this news is bittersweet, since the technology the Abbot stent relies upon was acquired from Boston Scientific as part of the Guidant deal. The saving grace here is that Boston

## Sound Advice: Portfolio Updates for April 2007

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retains the right to use that technology in exchange for royalty payments to Abbot. The core of the Boston Scientific story remains that buying BSX today gets us both BSX and Guidant at what either company commanded when times were good. We're happy to take advantage of this buy-one-get-one-free sale. BSX has edged back toward \$15, and is off 5.1%, while JNJ is off less than 1%. **Schering-Plough** got a boost from the New Orleans report, since it makes a unique drug to treat high cholesterol, and is up 8.4%. There was other news: SGP is considering marketing a combination of its Zetia with Pfizer's Lipitor once Lipitor comes off patent. Also, SGP announced it would acquire Organon Biosciences from Azko Nobel for \$14.4 billion in cash. The deal would bring new products and boost SGP's veterinary business. Since the last letter, SGP is up 8.4%, and even more from when the market flinched after the Oganon deal was announced.

We saw a similar shudder from Wall Street when **Perrigo** recently announced it was in agreements to acquire two companies, both of which are expected to add to earnings almost immediately. On the news, investors knocked it down to \$16.11. Since then, it's rebounded to \$18.22, a 13.8% jump, and 10.8% since the March letter..

### **NATURAL RESOURCES AND FOOD**

Across the board natural resources stocks are moving higher once more thanks to some old boosters: bad weather, China, geopolitical instability, refinery problems, and concerns that despite initial interpretations of the Federal Reserve's mood following its last FOMC meeting that the Fed did not expect inflation to be a problem, the Fed Chairman says that inflation

remains the Fed's primary concern. **Anglo-American** is up 14.6%, though you'd be hard pressed to find any substantial company specific news. **Icon Energy Fund**, which is strong on energy-service companies, added 8.2%, and **EnCana**, the Canadian independent energy company focused on natural gas and with significant exposure to oil sands plays, moved up 9.2%. **Transocean**, the premier deepwater driller, added 5.8%. **Royal Dutch Shell**, our integrated multinational energy company, is up 3%. **Plum Creek** is up 2.3%. **American Century Global Gold Fund** added 8.4%, but the silver miner, **Coeur d'Alene**, is flat after it received an adverse ruling about disposal of mining waste from its Kensington gold mine in Alaska. We're willing to wait and see what the company can do to satisfy regulators and the courts. Corn-based ethanol is siphoning corn away from our diet and into our gas tank, a trend that had pushed corn prices above \$4 a bushel (it's now in the mid-\$3s), and is seducing farmers into planting corn instead of other food crops. **Agrium** obviously has benefited from greater demand for fertilizer (corn needs more fertilizer than do most other crops), and the irony is not lost on us that we recommended Agrium originally in part because it had access to cheap natural gas, the feedstock for nitrogen-based fertilizers, and thus was a stealth play on rising energy prices. Now, as an input for corn, it is playing a different stealth role in the energy story. AGU was flat.

One grain-based position has been bubbly: **Molson Coors** added another 9.9% since the March letter, and is 25% to the good for 2007. We think investors consider beer makers a good bet when defensive positions beckon. Both TAP and Budweiser have outperformed the S&P 500 going as far back as 1990, and despite

being distinctly the smaller of the two, Molson Coors lately has been outperforming Bud. There also could be a consolidation wildcard at work, though we do not suggest you take a position in TAP in hopes that somebody will come along and speed up your profit accumulation. **Safeway**, which sells beer and a lot more, is doing well, suggesting that investors think it will be able to pass on to shoppers higher food prices. SWY added 6%.

### **MEDIA**

Some of our best performers last month were companies like **Discovery Holdings**, a **Liberty Media** spinoff, which announced it was buying out Cox Communications 25% ownership in DISCA. This in part explains the shares' 16% jump since the last letter. Another Liberty Media spinoff, **Liberty Global**, is buying back shares, and is up 14.6%. LBTYA has been telling large investors that it will be doing deals to increase liquidity, which sounds as if management wants to spinoff or sell assets. **Liberty Capital**, yet another Liberty Media offspring, added 3%. **Time Warner**, which so far this year has been giving back nice gains from 2006, rose 5.9% as investors put into perspective the valuation the market is placing on Time Warner Cable, of which TWX sold 15% in a recent IPO. Shares of TWX and the cable company have been tracking each other lower, though the 85% of the cable company TWX retains represents only 40% of TWX's value. We think investors will see that, and begin to value TWX as a whole again. **Disney** has been quiet for a while, and **Comcast** has given back some of last year's big gain, though both nudged higher last month. **Sony**, which was flat (-0.7%) over the last month, has had a great 2007 (+21.7%). **SA**

# Sound Advice Portfolio for April 2007

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$12.48	6.73%	\$14.00	BUY
Senior Housing Properties	SNH	NYSE	\$24.75	5.49%	\$27.00	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$39.42	0.28%	\$42.00	BUY
American International	AIG	NYSE	\$67.23	0.74%	\$75.00	BUY
Boston Scientific	BSX	NYSE	\$14.97	0.00%	<b>\$17.00</b>	BUY
Coca-Cola Enterprises	CCE	NYSE	\$20.54	1.17%	\$24.00	BUY
ConAgra	CAG	NYSE	\$24.73	2.91%	\$29.00	BUY
CSX Corporation	CSX	NYSE	\$40.96	0.98%	<b>\$46.00</b>	BUY
Disney	DIS	NYSE	\$34.91	0.89%	\$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$46.75	1.22%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	\$55.38	0.87%	N/A	BUY
<b>Fastenal</b>	<b>FAST</b>	<b>NASDAQ</b>	<b>\$35.60</b>	<b>1.18%</b>	<b>\$39.00</b>	<b>BUY</b>
Fidelity Japan Fund	FJPNX	800-544-8888	\$17.74	0.00%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$24.13	0.58%	N/A	BUY
Getty Images	GYI	GYI	\$49.99	0.00%	\$56.00	BUY
Honeywell	HON	NYSE	\$47.26	1.92%	\$50.00	BUY
Johnson & Johnson	JNJ	NYSE	\$61.55	2.44%	\$69.00	BUY
Liberty Capital	LCAPA	NASDAQ	\$111.46	0.00%	<b>\$118.00</b>	BUY
Mattel	MAT	NYSE	\$29.65	2.19%	<b>\$32.00</b>	BUY
McDonald's	MCD	NYSE	\$45.78	0.50%	\$47.00	BUY
Molson Coors Brewing	TAP	NYSE	\$94.89	0.86%	<b>\$100.00</b>	BUY
Newell Rubbermaid	NWL	NYSE	\$31.32	2.68%	\$32.00	BUY
New York Times Co.	NYT	NYSE	\$23.43	2.99%	\$27.00	BUY
Perrigo	PRGO	NASDAQ	\$18.22	0.99%	\$20.00	BUY
Safeway	SWY	NYSE	\$36.32	0.64%	\$38.00	BUY
Sara Lee	SLE	NYSE	\$16.99	2.35%	\$18.00	BUY
Schering-Plough	SGP	NYSE	\$25.86	0.85%	\$28.00	BUY
Sony	SNE	NYSE	\$52.12	0.41%	\$55.00	BUY
Sprint Nextel	S	NYSE	\$19.60	0.51%	\$21.00	BUY
Superior Industries	SUP	NYSE	\$22.27	2.87%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$18.71	0.00%	\$20.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$62.38	5.35%	N/A	BUY
United Parcel	UPS	NYSE	\$70.26	2.16%	\$82.00	BUY
Wal-Mart Stores	WMT	NYSE	\$48.27	1.39%	\$52.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$60.59	3.16%	N/A	BUY
Xerox	XRX	NYSE	\$17.34	0.00%	\$18.00	BUY
<b>Energy/Natural Resources</b>						
American Cent. Gold Fund	BGEIX	800-826-8323	\$19.98	0.25%	N/A	BUY
Anglo American PLC	AAUK	NASDAQ	\$27.02	1.81%	\$29.00	BUY
Coeur d'Alene	CDE	NYSE	\$4.28	0.00%	\$5.50	BUY
EnCana	ECA	NYSE/TSE	\$52.07	1.15%	<b>\$56.00</b>	BUY
Icon Energy Fund	ICENX	800-764-0442	\$34.09	9.86%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$39.49	4.05%	\$41.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	\$67.04	3.65%	\$74.00	BUY
Transocean	RIG	NYSE	\$82.10	0.00%	<b>\$86.00</b>	BUY
<b>Aggressive Growth</b>						
<b>Comcast</b>	<b>CMCSA</b>	<b>NASDAQ</b>	<b>\$26.61</b>	0.00%	<b>\$30.00</b>	BUY
Crescent Real Estate	CEI	NYSE	\$20.41	7.35%	\$22.50	BUY
Discovery Holdings	DISCA	Nasdaq	\$19.99	0.00%	<b>\$22.00</b>	BUY
Electronic Data Systems	EDS	NYSE	\$27.71	0.72%	\$30.00	BUY
Liberty Global	LBTYA	NASDAQ	\$34.83	0.00%	<b>\$36.00</b>	BUY
Maxim Integrated	MXIM	NASDAQ	\$29.70	1.89%	<b>\$33.00</b>	BUY
Mitsubishi UFJ Financial	MTU	NYSE	\$11.56	0.82%	\$16.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$5.87	1.70%	N/A	BUY
Symantec	SYMC	NASDAQ	\$16.92	0.59%	\$22.00	BUY
Time Warner	TWX	NYSE	\$21.84	1.01%	\$22.00	BUY
Western Digital	WDC	NYSE	\$16.77	0.00%	\$20.00	BUY

\*Prices as of the market close on Thursday, April 5, 2007 (Market closed on 4/5/07, Good Friday)

\*\*Yield represents all distributions during current calendar year divided by share price.

**BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT**

(...continued from inside front cover...)

that the economy was doing fine, and that there was little to worry about. Bernanke added other issues that could go wrong, but his major worry still is inflation.

If inflation is in the air, investment preferences tend toward beneficiaries of inflation. Precious metals, timber, commodities in general, and real estate are the obvious candidates. Equities in other countries also could benefit if inflation is accompanied by a falling dollar. Even some equities here in America are worth overweighting, and would include things consumers have little or no discretion over, such as medical care, food, and other necessities. Our portfolio is strong on such sectors, in

part because when we picked them up, the market had priced them too cheaply when a slowing economy and/or inflation seemed unlikely.

We're doing acceptably so far. *The Sound Advice* portfolio is up 3.5% through April 5th, which beats the Dow (+0.8%), S&P 500 (+1.8%), and the Nasdaq (+2.32%). We think the rest of the year will prove more profitable. If you see an alert in red above your address that your subscription is expiring, please take advantage of our generous resubscription offers. We've outperformed the market for years, and expect to continue that. We hope you stay with us.

## The Sound Advice Market Indicators:

**The Diffusion Index of Leading Indicators** gives “buy” signals when all five of its leading economic indicators drop below their respective levels of six months earlier. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates. **Currently, 40% of its leading indicators are above their levels of six months earlier.**

**The Diffusion Index of Lagging Indicators** gives “sell” signals when all five of its lagging economic indicators rise above their respective levels of six months earlier. This reveals a strengthening economy and inflationary pressures ahead. **Currently, 62.5% of its lagging indicators are above their levels of six months earlier.**

While we recommend remaining fully invested in the *Sound Advice* model portfolio at all times, we use the *Sound Advice* Market Indicators to influence our approach and nature of our recommendations. When “sell” signals are in force, our recommendations are defensive in nature and we are likely to recommend taking profits more readily. Conversely, during “buy” signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market.

**The latest signal came from the Diffusion Index of Lagging Indicators, a 100% reading in October, which constitutes a “sell” signal.**

**The Risk Indicator**, which tracks the Supercycle, the overarching investment climate as expressed by the relative prices of real estate and equities, remains firmly in favor of equities being overpriced versus real estate. The current reading stands at 2.77 up from last month's 2.7.

### History of the Signals

- \* 2003 In March, just before the surge in the market, the indicators gave a buy signal. The S&P 500 advanced more than 40%.
- \* 2000 In May, close to the peak of the market, the indicators signaled the end of the bull market. The market subsequently dropped 40%.
- \* 1995 In March, the indicators gave a sell signal. Then in July, they gave a buy signal. The S&P rose 153% until the next sell signal in May 2000.
- \* 1988 In January, the indicators signaled the subsequent bull market that took stock prices up 95% until the next signal.
- \* 1987 Six weeks before the 1987 Crash, the indicators gave a sell signal.
- \* 1981 A buy signal occurred close to the beginning of the next bull market that carried stock prices up 145%.
- \* 1980 A sell signal warned of that year's bear market.
- \* 1974 With the Dow Jones trading below 700, the indicators issued a buy signal, announcing a 6-year bull market.
- \* 1973 They signaled a “sell” just prior to the bear market that cut stock prices in half by October 1974.
- \* 1970 The indicators signaled the beginning of the new bull market.
- \* 1968 At the zenith of the huge bull market of the 1960s, the indicators gave a sell signal before a 25% decline.

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