

David Tepper Again



F. Scott Fitzgerald got it wrong when he said that there are no second acts in American lives. Consider Henry Blodget, who today is a media personality, interviewing important people on important, or at least juicy, topics. He presents himself as a knowledgeable, dispassionate observer of the financial services industry, overlooking that his unethical behavior a decade ago caused him to be barred from working in it.

Blodget, back in the tech heyday was an analyst at a second-tier brokerage. He boldly predicted as the Internet bubble built that Amazon would break \$400, which after jumping 128% it did just weeks later. That earned him instant fame and a top Internet analyst job at Merrill Lynch as the tech bubble was exponentially expanding. In the messy aftermath, Blodget and many other high-powered analysts were revealed as shills who in their research reports praised firms, which privately in their emails they considered “crap,” in order to win from those praised companies ultra-lucrative investment banking deals for their own brokerages.

Last week, Blodget interviewed Michael Lewis (*The Big Short*), who just published in *Vanity Fair* an article about a Merrill Lynch banking analyst who in our own decade’s bubble, but before it broke, got fired for predicting unflatteringly that the Irish banks would implode. Without a trace of irony, Blodget mocks Merrill analysts who “go to management and ask what you’d like me to say,” chuckling, “I thought we were done with that but I guess not.”

As you know, I’m very skeptical about analysts, if only because they tend to move as a herd and usually are behind, not ahead of events. More darkly, they don’t have to be flim-flam men like Blodget was, they just have to be conflicted. I’m more comfortable with sources like *Morningstar* and *Value Line*, if only because they have minimal, or as is the case at *Sound Advice*, zero conflicts of interest when they offer advice about stocks and funds.

-Gray Emerson Cardiff

The October 2010 cover essay focused on David Tepper, the head of Appaloosa funds, whose appearance on CNBC’s Squawk Box before the market opened on September 24th is popularly credited with calling the bull run that has continued to the present. Indeed, CNBC likes to refer to what happened as “The Tepper Rally.” His thesis was simple: the Fed in the face of a still sluggish U.S. economic recovery actively must generate economic growth and, if the economy did not on its own get going soon, the Federal Reserve would do everything it could to stimulate the economy by creating inflation that would force the economy forward. Quantitative Easing would be—is intended to be—inflationary, something, Tepper asserts, the Fed never before had promoted (he’s wrong about that. The Fed did exactly that back in 2002). “Either the economy gets better by itself,” which means that stocks will flourish while bonds and gold will take a back seat, Tepper speculated, or the Federal Reserve intervenes with Quantitative Easing, which in the near term means everything benefits, though in the longer term it will be negative for bonds.”

In fact, the S&P, which as Tepper laid out his view that morning stood at 1124, already was 7% above its August 24th bottom. But that would be quibbling. What followed vindicated almost everything Tepper said. The S&P is 16.3% higher. He anticipated Quantitative Easing, anticipated that stocks of all stripes would flourish. His only mistake was being bullish about bonds. The previous day, the yield on the 10-Year Treasury Note had been 2.56%. Today, it’s 3.6%. Had you owned the iShares Barclays 10-20 Year Treasury ETF (TLH) as Tepper spoke, you’d have lost about 9% (after dividends). Ironically the very reasons he presented for equities to do well (the global economy is looking better and we got that dose of QE) have hurt Treasuries as fears of deflation receded. Nonetheless, anyone who followed Tepper’s lead has done handsomely.

This brings us to Tepper’s return visit to CNBC before the market opened on January 20th. Now the S&P was at 1282 and Tepper, though still bullish, had tapered back his appetite for equities. No longer was “everything” worth buying. The downside had expanded. His only regret looking backward was that he had not been shorter bonds. What did he now like? He was refreshingly reticent, and unlike most CNBC professional investors, he didn’t talk his book. But he said he liked semiconductors “across the board.” (*Maxim Integrated* is working for us).

What does Tepper buy? He illustrated that with a negative case, PNC Financial, which the other guest that morning, James Rohr, happens to run. As Tepper put it, PNC “is so well run and has stable, great management for so long that we kind of hate the thing. There’s nothing screwed up about it for us to invest in.” As a summation of *Sound Advice*’s attitude toward investing, we could not have said it better (See Page 2). SA



Healthcare and the Business Cycle: The Daily Double

There are few more reliable trends, provided you look forward, in which to invest today than healthcare, which is why we were unfazed by—we even welcomed—the chaos and pessimism that surrounded the drafting and passage of the Affordable Care Act. If you believed the faux Cassandras, passage would destroy HMOs, drug companies and device makers. Accordingly their stocks were hammered. Approximately 32 million Americans who were uninsured before are on their way to gaining some form of medical coverage. Politics being politics, the law is again under siege in Congress and the courts but, we believe, politicians will cobble together compromises to retain the core changes. Add to that the demographic tide of baby boomers, whose vanguard this year begins to turn 65—about one every eight seconds. As each of that 70-million demographic tsunami begins to access Medicare, their use of the U.S. healthcare system will rise. Some of these boomers have had no health insurance and others, though insured, when the medical need was not urgent or life-threatening might have hesitated to use that insurance because of hefty deductibles and/or copayments. Those obstacles have now diminished. The elderly are the prime customers for drugs, medical devices, hospital stays and every other facet of healthcare.

By next year at this time, we expect that backward-looking comparisons will be extremely favorable...Add to the benefits of economic recovery what we expect will be increasing demands for healthcare professionals, and we believe AMN offers an extraordinary opportunity. But you'll have to look forward to recognize that.

With the exception of **Boston Scientific**, about which we remain constructive and **Johnson & Johnson**, which has been wobbly of late, every healthcare position we've recommended has outperformed the overall market, sometimes spectacularly. There's nothing subtle about our reasoning. Indeed, the rationale is so blazingly obvious that every time we roll it out as a backdrop for yet another healthcare-related name, we wonder why any well run healthcare stock should be underpriced. But again and again, there they are. Which brings us to **AMN Healthcare (AHS—NYSE)**, a small-cap (\$240.9 million) provider of temporary medical professionals for hospitals, doctors offices and other medical facilities. We think demand is about to experience a sharp rise.

But there's more: the rationale for buying AMN Healthcare is a two-fer. AMN is not just an opportunity to invest in healthcare. It's also a chance to buy into a cyclical business toward the bottom of its cycle. That's right, though most healthcare companies as investments are considered non-cyclical, since when you need medical care for a serious issue—unlike wanting a new HD TV or dreaming about a vacation to Maui—you spend the money to take care of that need. But in a tight economy and job market, not only have many postponed elective or non-urgent medical care, which diminishes demand, but also many nurses, doctors and other skilled professionals who in better times might retire, take leaves or move on to new positions hold on to their current jobs. And when medical facilities have to reduce staff, the first to go usually are the temporary workers.

We want to own AMN before investors not only get excited by how well healthcare shares will do but also before they are convinced that the economy has righted itself. If we're right about demand for healthcare and the direction of the economy, AMN should move into a very profitable phase.

AMN Healthcare

AMN, which today in terms of revenues is the largest (by a factor of two) temporary healthcare staff agency, started in 1985 as a local company providing temporary nurses to hospitals and other medical facilities. It came public in 2001 after a period of extraordinary growth that tracked the economic expansion of the 1990s—not surprising given both rising demand for temporary nurses and the small revenue base from which the company grew. Revenue during the previous six years had risen at a compounded annual rate of 48%, though one-third of that growth came from acquisitions. Regardless, 48% annual growth is a tough act to continue and with the exception of 2002 and 2006, AMN even in good years grew sales organically only by single digits.

AMN's original business was focused on filling hospitals' demand for temporary "travelers," registered nurses, whose assignments took them to other locations where they would move into apartments, work and, when their contracts ended, return home. Since the IPO, there have been a half dozen acquisitions most of which reinforced the core traveling nurse business, while others introduced complementary short-term physicians, pharmacists and allied services workers. Another acquisition introduced a program for permanent placements for physicians. Another brought in house O'Grady-Peyton, a firm that recruits foreign nurses for assignments in the United States.

AMN's typical assignment for a traveling nurse lasts 13 weeks but can extend for as long as a year, and usually fills vacancies created either by resignations, a long-term absence, to meet an expected spike in workload or as a way of filling what could be a permanent position at a time, such as now, when employers are reluctant to commit to a longer-term contract.

Placing registered nurses and allied service support has been the core business (52% of revenues and 51.3% of operating profits for the first three quarters of 2010), but temporary physician assignments now account for 41.7% of revenues and 36% of operating profits, while permanent physician placements brought in 3.5% of revenues and 1% of operating profits.

Medfinders

The newest revenue segment, home healthcare, appeared for the first time in Q3, and represents only a single month's contribution of 2.9% (both revenue and operating profit) for

that quarter. It came as part of the most recent acquisition, Medfinders, which was completed late in Q3. Quality home healthcare for patients released from acute care facilities will have a prominent role both in keeping expenses down relative to hospital or other care facility costs and in reducing the number of re-admissions. Another significant business line that Medfinders added involves managing temporary staffing.

The Medfinders acquisition caused consternation on Wall Street because of its price (\$193 million) that was paid with debt and new shares, and because adding depth at a depressed period in the industry's business cycle worried investors. The shares lost more than 40% in the four weeks after the deal was announced (July 28th) until they bottomed at \$4.34. Since we are coming in after a vicious sell off, we can pick up AMN at a fat discount not only to where we see the company today, but even more from where we think it can go.

In fact, we like what the Medfinder deal does for AMN. Medfinders, like AMN, is a national company, but is strong on local per diem placements and weaker on traveling nurse assignments, which nicely complements AMN, which had been weak in local and strongest on traveling nurses.

But the more significant part of the story is what Medfinders brings that is new. AMN had been slowly building its managed staffing services, which give it exclusive responsibility for filling clients' temporary employment needs. For employers, managed plans reduce the number of vendors needed and for AMN it provides a higher fill rate. For Medfinders managed services for hospitals had been a primary business, which will accelerate AMN's own efforts in that area. AMN now has 110 managed services contracts that cover more than 350 facilities around the United States. Management estimates that with their combined managed services programs the company has a realistic opportunity for another \$100 million in billing from existing clients that either would have gone to its own subcontractors or to other agencies. Medfinders also brings a vendor management system for hospitals, in which it managed employment of temps from other healthcare agencies.

The substantial increase in managed services and vendor management services is expected to generate next year 18% of revenues and per diem local staffing will go from basically zero at the old AMN to 8%. Home healthcare will account for about 6%, while the core lines of the old AMN will decline from 51% to 35% for traveling nurses and allied services and from 44% to 29% for temporary physician placements. In effect, the new company is complementing its traditional role as a provider of workers with a new dimension of managing its clients' temporary staffing needs.

But AMN has to sell itself not just to firms that need medical staffing. They also have to sell the company to nurses and other medical professionals. With the exception of physicians who are treated as private contractors, AMN's other workers are W-2 employees, though that employment ends when each placement contract ends. In practice, AMN does not have a permanent retinue of nurses and allied professionals. Instead, the company maintains a registry of freelancers who commonly list their services with other temp agencies. AMN is well regarded by its clients for the quality of its temps, which is crucial for repeat business. It's also well regarded by its medical professionals, whom AMN woos with pay, benefits

and the range of locations its national reach provides.

Regionally AMN derives the largest portion of revenue from California followed by Texas, Florida and New York. The company as it has grown has seen its revenue growth moderate, though at peaks in years such as 2003-2004 and 2006-2007 revenues, cash flow and earnings rose sharply along with the share price only then to tumble lower. As of its most recent 10Q (September 30, 2010), management noted that though it's seen an uptick since mid-2010, the numbers remain well short of what had been experienced before 2009.

Medical Temps and the Business Cycle

The problems besetting AMN and its competitors are primarily cyclical: during and in the aftermath of a recession, clients' constrained resources reduce demand for additional temps and, more important, difficult economic conditions discourage permanent staff (93% of RNs are women, often the secondary breadwinner in a household but less likely than their spouses to be unemployed during hard times) from dropping out of full-time employment, which decreases turnover and thus cuts opportunities for AMN to fill vacant slots.

Then there is the decline in demand for medical services during a downturn. Admissions to non-profits in 2009, for instance, declined for the first time since Moody's began tracking that number in 1981, though admissions to profit-based hospitals did increase (but just barely) that year.

In 2009, AMN experienced its biggest drop (-37.6%) in revenues, while net profits, thanks to write-offs, nearly vanished, down 97.4%. The share price, after hitting its all-time high (\$29.10) at the start of 2007 while the economy still was humming and revenues and earnings were rising fast, started to fall and didn't stop till March 2009 (\$4.60), rose for a few months but then fell again last August after the Medfinder deal. We cannot stress enough that AMN's core lines of business are highly cyclical. We should invest in it accordingly: start buying when business is slack and employment weak—like now.

Impairment Charges

Diminished revenues were only half the story. Because AMN has used acquisitions to expand, its balance sheet carries a significant amount of "goodwill," which is accountese for whatever an acquirer pays in excess of the target's book value. Usually that amount is justified by projecting the synergies of adding a new asset. However, when a company acquires assets and then encounters difficult market conditions, those expected benefits don't happen. Annually companies must review the goodwill on their balance sheets and if it is judged "impaired," the company must reduce not only the value of goodwill on the balance sheet but also write off that amount as a charge against earnings.

Hence, in the 2009 10K AMN decreased the goodwill it carried from \$252.9 million to \$79.9 million. That \$173 million impairment when it migrated to the income statement became a non-cash write-down that resulted in a \$3.75 per share loss for the year. In the most recently reported quarter (September 30, 2010) AMN took another impairment charge, this time for \$48.9 million, which translated into a \$1.48 per share loss for

the quarter. Such charges tend to terrify Wall Street. From our perspective as new buyers, the damage to the balance sheet and income statement are history. Indeed, when demand for AMN's services picks up along with the economy, we'll have a chance to see how much of those projected synergies will be translated into higher revenues and earnings. Nonetheless, for the past few years, temporary staff providers have been swimming against the tide, which we see in reduced billings and these impairment charges. The question is when that pressure slows or even reverses. It's possible we are seeing the first evidence now.

Employment Is Turning Upward

AMN has reported improving operational results for the last two quarters as the worst downdraft in job destruction seems to have passed, though nationally unemployment still stood in December at 9.4%. As we close the February issue, the Bureau of Labor Statistics (BLS) has announced that for January unemployment dropped to 9%, though weather-related issues obscure what this number means. Until proven otherwise, job creation remains anemic, but it's an improvement over relentlessly rising unemployment figures that early in 2008 began to move from the low 4% range and exploded at the end of 2009 to as high as 9.9%. The BLS' most recent employment survey shows that education and health services added 44,000 new jobs (of a total of 137,712 new jobs overall) in December 2010, and it was healthcare that dominated that combined tally. Only leisure and hospitality in December accounted for more new jobs (47,000).

In healthcare, the largest job creator (average increase of 20,700 a month for the last year), was ambulatory care, an amorphous category that covers treatment and procedures provided on an outpatient basis. Hospitals and care facilities were the second biggest contributors, adding on average 3,800 new hires each month. Indeed, every healthcare sector showed accelerating job creation as 2010 drew to a close. The figures for January 2011 are just coming in as we finish our research, and though they were not encouraging as regards the broad economy, they show continued strength in job creation in the healthcare sector with the strongest growth in ambulatory services and home care.

Keep in mind that there is not a vast pool of unemployed healthcare professionals. According to the BLS, unemployment for these sectors, always the lowest for non-government jobs, stood at 5.6% in December 2009 and 12 months later had fallen to 5.2%. Any increase in demand will put pressure on existing medical professionals, which should be an opportunity for the temp providers. Projections both for demand and a persistent undersupply of nurses and other medical professionals over the next decade set the table for plenty of work for AMN nurses, doctors and allied staff.

In AMN's Q3 revenues ticked up 6% as did gross profits. Nursing and allied services generated 13.3% more in sales, though revenue from the temporary placement of doctors fell 7.9%. We expect when the company issues results for Q4 in early March that, if the latest figures for national employment and GDP growth are true indicators, we'll see further revenue

expansion at AMN, the preliminary stage for a return to profitability and a higher share price.

Competition and Consolidation

AMN might be the industry's giant, but that's only because the industry is extraordinarily fragmented and is ripe for consolidation. On one list of traveling nurses, we counted 480 agencies, though many might consist of nothing more than a lone entrepreneur with a modest Rolodex of RN's names and a telephone. We found another list for placing temporary physicians, and counted 58 companies.

Consider that billing for temporary nursing services in 2010 was \$8.2 billion. Of that, the 19 largest firms, most just a fraction of AMN's size, accounted for \$4.2 billion, leaving just under half atomized among even smaller competitors. AHN accounted for \$717 million (8.7%). The next largest competitor, CHG Healthcare collected 6.1% while Cross Country took in 5.7%. It's reasonable to presume that the largest players will take market share away from the smaller, which plays into AMN's strengths. For that matter, among the truly large temporary employment providers like Adecco, Manpower, Kelly and Robert Half, only Kelly has any significant presence in providing temporary nurses and physicians. Would one of these, should it recognize the tide rising toward healthcare, consider swallowing a national agency like AMN? It's something to think about. But for us to realize AMN's potential, we needn't dream about it going on sale to some larger company. It's cheap today.

Valuations

The Medfinder deal was done using new shares and debt, and increased long-term debt on AHN's balance sheet to about where it stood in 2005 after a series of earlier acquisitions. We're confident the company, as it did over six years ago, will reduce that debt from cash flow. The issuance of new shares, which is happening in two stages, the first of which occurred at the time the deal closed and the second, involving conversion of a special preferred issue, increases the number of shares by about 26%. As suggested, we think the Medfinder deal will work out well for AMN.

Given the impact write-offs of goodwill have had on earnings, we'll not consider the Price/Earnings ratio. Also, the costs involved in the Medfinder acquisition, a significant but one-time event, reduced cash flow by \$235 million, which diminishes the relevance for the latest Price/Cash Flow ratio. But Price/Book is at 1.5 versus an industry average of 2.7, and AMN's own five-year average of 2 encourages us. Price/Sales is at 0.3 versus an industry average of 0.7 and its own five-year average of 0.5.

AMN and the U.S. economy are emerging from an extraordinarily difficult period of contraction. By next year at this time, we expect that backward-looking comparisons will be extremely favorable for both. Add to the benefits of economic recovery what we expect will be increasing demands for healthcare professionals, and we believe AMN offers an extraordinary opportunity. But you'll have to look forward to recognize that. We recommend buying AHS up to \$8. SA

Portfolio Updates

Since we priced the January issue, the Sound Advice portfolio is up 3.5%, which matches the Dow's gain and leads the S&P's 3.1%, the Wilshire 5000's 3.3% and the Nasdaq's 2.5%. After pacing the rally that started in March 2009, the Nasdaq for the moment has fallen to the back of the pack as the Dow's mega-cap stocks have surged to the lead. Treasuries, which had flourished during the cheap interest rate environment, however, stumbled again despite the Fed keeping short-term rates effectively at zero and pumping cash into the economy through quantitative easing. **ProShares UltraShort 20+ Year Treasury ETF**, which with 2X leverage shorts longer-duration Treasuries, pushed above \$40, up another 6.7%. Not all bonds react in the same way to rising interest rates as do Treasuries. Junk (AKA "High Yield") bonds are insulated to a degree when rates rise—provided the rise is associated with improving economic conditions—and can act more like equities, that is, because conditions are improving, there is less concern about the issuers' survival. Hence, our **Third Avenue Focused Credit Fund** added 1.7%. Gold, the other bellwether for economic anxiety, suffered as concerns over deflation have all but vanished. Indeed, the media (and our subscribers, if our emails are any indication) want to talk about inflation as reflected in rising costs, particularly for food and energy, though we are also seeing instances of companies starting to pass on their higher costs to their customers. Higher labor costs, even in a 9% unemployment environment, are popping up. **USAA Precious Metals & Minerals Fund** dropped 1.3%. We'll continue to hold the fund, since we believe that investors will find hard assets attractive should inflation take serious hold. REITs might be one equity class that also would benefit with a touch of inflation as landlords can start raising rents, something we are already seeing in the apartment sector.

The January recommendation, **Associated Estates Realty**, an apartment REIT, added 0.5% (including a 17 cent distribution on 1/12) as apartment REITs, though they continue to be talked up as the sector to be in, were mixed. It didn't help that on the day we priced our portfolio (1/7) AEC matched its recent high (\$15.41) as buyers scrambled to get into the shares before they went ex-dividend after that day's close. Our take on AEC was reinforced at the recent conference sponsored by the National Multi-Housing Council, which projects the highest rate of rent increases for Class A properties, the segment toward which AEC is gravitating, and the lowest rate in older properties, the class out of which AEC is moving. We're happy to own these shares with an above-average dividend while the company reshapes its inventory into a more desirable mix that eventually can command higher valuations.

Commonwealth REIT, the old **HRPT Properties Trust**, is making up for last year's lackluster performance with a 5.8% rise on a total return basis (50 cent dividend on 1/19)

since the last letter as office and light industrial REITs are responding to improvements in the U.S. economy. **CGM Realty Fund** is up 3.7%. We intend to dissect its portfolio in the March issue that will be devoted to funds.

Plum Creek Timber, structured as a REIT but really a land and lumber company, is up 3.7%. PCL, if looked at as a timber play, is a bit pricey but when considered as a real estate asset, the company makes more sense. The challenge for PCL is waiting for demand for land to resurface. In the current market for housing, a prime use for PCL's acres, that wait seems long.

Changing views about Beijing's interest in slowing growth in order to blunt inflation have whipsawed investors. Are interest rates rising to discourage speculation for property and to restrain the building of new capacity? If so, commodity prices fall sharply. But can China afford to slow its rate of growth too abruptly and risk disquieting a population that depends on new job creation and growth? Lately the pendulum has swung toward slowing, and commodity prices weakened.

Anglo-American, the mining company, after being drubbed during the sharp correction in commodities, rebounded and is up 5.2% since the January letter.

EnCana, the Canadian natural gas company, that we recommended be bought as Wall Street fretted about an oversupply of natural gas, is up 11.7%. Cold weather has helped, but there might be a longer-range rationale for the move. As we discussed in that December recommendation (Buying Into Oversupply), gas prices have been depressed by the rich production from shale deposits. One solution would be to export liquefied natural gas to foreign markets where prices are higher. Plans to do just that are gaining traction, and might explain why ECA and others are showing strength. Another reason might be continued interest from China in acquiring assets. ECA back in mid-2010 had entered into a preliminary agreement with China National Petroleum to develop its British Columbia field and now seems to be moving to specifics. No, we don't imagine a Chinese buyer might bid for ECA. Just having a partner with such deep pockets and a keen need for energy is enough to enhance ECA's prospects and share price.

Fidelity Select Natural Gas Fund is up 4.8%. Our other energy investment, **Transocean**, added 6.6% despite concerns it might have to shut down the five rigs operating in Egyptian waters.

Leucadia, that grab bag of a holding company that we've loved to own (this is our second engagement), is up 11.5%. LUK has significant exposure to commodities. LUK is involved in the development of two facilities for importing natural gas (though one just ran into regulatory issues in Oregon)—not exactly a hot item in today's market—but these facilities might be candidates for development for the export

market. Leucadia quietly has gotten itself into alternative energy sources such as coal gasification and co-generation projects around the country. If energy independence moves from political posturing to real policies, some or all of these projects could be quite lucrative for Leucadia.

Leucadia owns an 18% interest in Inmet, which will combine with Lundin Mining to form a \$9 billion market cap copper mining company. Consider that LUK owns its shares after selling Inmet its interest in a Spanish copper mine that cost \$42 invested 12 years ago. If you factor in transactions LUK made along the way, its foray into a start-up copper venture was a 22-bagger

Agrium, the Canadian fertilizer company, during the commodities sell-off fell under \$87 but as prices recovered finished down only 0.5%. Rising food prices are part of the fuel for the anti-government/pro-democracy upheavals in North Africa. We're seeing similar food inflation in India and elsewhere. The U.S. is not immune either. Here in the U.S. we're also seeing rising food prices.

Telecom and media stocks were mixed. **AOL** dropped 7% after reporting higher earnings that resulted not from higher revenues (they fell) but from reduced expenses. Though we have thick skins when it comes to companies trying to refashion themselves, we are parting ways from AOL and can only hope for its remaining shareholders that we are wrong. [Sell AOL](#).

AOL came into our portfolio when **TimeWarner** spun off its erstwhile merger partner farewell in December 2009. We bought after the shares had been massacred. Fortunately TWX, the part we always thought had real value, hasn't disappointed. It closed this month at \$35.92, up 7.9% as its advertising revenue on its TV stations rose as did income from its movie arm. The annual dividend is to be increased to 85 from 75 cents a share. **Comcast** added 2.5% after consummating its acquisition of NBC Universal from GE.

Telecom New Zealand intends to split into its traditional landline assets and broadband assets, but won't until the central government decides to what extent Telecom will be involved in the country's planned ultrafast broadband network. Last year, shareholders were shaken when regulators announced that NZT had not been selected to participate in two of the smaller parts of that project, but since then it's becoming clearer that the company will be the central player in the overall system. NZT is 5.9% higher since the last letter. **Gamco Global Telecommunications Fund**, which has positions in both Comcast and NZT, is up 2.6%.

As for technology, **Microsoft** continues to confound, losing 2.9% since the last letter, despite several positive trends evident in Q2 results announced last week. Office 2010 is being bought strongly and the Kinect game system has leapfrogged its competitors, yet Wall Street remains unconvinced that a company that has come to be seen as yesterday's news has what it takes to compete.

Symantec reported good results for the quarter and encouraged investors with talk about how its storage and massive data management division could benefit from

growth of cloud computing and the growing issue of mobile device security, a new frontier for a company that had focused on desktop and laptop security. Since the last letter, SYMC is up 3.5%.

Xerox is having the weakest showing, down 4%, after projecting lower than expected results for the coming quarter and (depending on which set of numbers you use) met or either slightly exceeded or slightly fell short of expectations for the past quarter. We still like XRX, whose turnaround is proceeding nicely.

Maxim Integrated, the analog and mix-design chip manufacturer, surprised with higher than expected revenues and earnings and also projected similarly better results for the next quarter. Unfortunately MXIM chose to do this on a bad day for tech stocks, and the shares didn't get much of a boost. But since then investors have shown more interest, pushing MXIM 9% higher.

The closed-end **Columbia Seligman Premium Technology Fund** is up 3%. We like the fund not only because it continues to trade at a discount to its Net Asset Value but also because it does best in moderate markets when the options it sells don't get exercised. In a sharply rising market, those options can get expensive fast and cut into the portfolio's performance.

Healthcare was mixed. While **UnitedHealth**, the HMO added 10.5% after a good quarter and **Pfizer** followed suit, though its quarterly gain was primarily the result of accounting. Nonetheless, PFE added 6.3% on a total return basis. **Stryker** reported better sales for its orthopedics products but even better for its hospital supply division as hospitals, which put off capital expenses during the recession and as the healthcare industry tried to decide what the new federal law would mean, by necessity have increased orders. SYK is up 7.7%. However, **Boston Scientific**, after reporting a good quarter and expressing confidence about the future, added in its conference call that 2011 would be a "challenging year," which did not help the shares. Add to that bit of candidness that the Department of Justice has joined in a suit involving the same Guidant defibrillators that recently figured in what was thought to be the last phase of that problem, and the shares 4% drop comes into focus. We're still constructive about BSX but can understand why others' patience might be getting thin. **JNJ** continues to trip over itself, dropping 2.8%. **Hambrecht & Quist Life Sciences Fund** continues to shine, adding another 3.8%.

Finally, two positions we see as clues to where the market thinks the U.S. economy is heading continue to show strength. **Paychex**, the payroll services company, is up 5.3% this month (23% since its recommendation in October) as we wait for quarterly results. **International Speedway**, which owns venues used primarily for NASCAR mega events, whose primary fans are young, blue-collar males (those most hurt by job destruction during the recession) added 10.1%. ISCA's performance suggests investors think more of these fans will find jobs and the cash to spend at NASCAR events, while the PAYX performance suggests that company will be handling their paychecks. SA

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.31	4.44%	\$17.00	BUY
CommonWealth REIT***	CWH	NYSE	\$26.99	7.41%	\$30.00	BUY
Telecom New Zealand	NZT	NYSE	\$8.68	6.35%	\$9.00	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$91.70	0.24%	\$95.00	BUY
CarMax	KMX	NYSE	\$34.02	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$27.75	2.23%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$23.27	1.40%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$36.71	1.35%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$113.99	1.08%	N/A	BUY
Fastenal	FAST	NASDAQ	\$61.58	2.05%	\$65.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$21.11	1.71%	N/A	BUY
Honeywell	HON	NYSE	\$57.12	2.12%	\$62.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$28.92	0.55%	\$32.00	BUY
Johnson & Johnson	JNJ	NYSE	\$60.84	3.55%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$33.31	0.75%	\$38.00	BUY
Mattel	MAT	NASDAQ	\$25.25	2.97%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$27.77	1.87%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$47.47	2.02%	\$54.00	BUY
Paychex	PAYX	NASDAQ	\$33.26	3.73%	\$40.00	BUY
Pfizer	PFE	NYSE	\$19.30	3.73%	\$21.00	BUY
Stryker Corp.	SYK	NYSE	\$58.51	1.03%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$20.47	3.13%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$23.99	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$53.38	1.81%	N/A	BUY
Time Warner	TWX	NYSE	\$35.92	2.34%	\$40.00	BUY
United Parcel	UPS	NYSE	\$74.34	2.53%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$42.49	1.18%	\$46.00	BUY
Wal-Mart Stores	WMT	NYSE	\$56.03	2.16%	\$60.00	BUY
Xerox	XRX	NYSE	\$10.85	1.59%	\$14.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$26.70	0.00%	\$30.00	BUY
EnCana	ECA	NYSE/TSE	\$32.07	2.49%	\$34.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.16%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$40.92	4.11%	\$42.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$19.57	0.52%	\$21.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$39.21	11.74%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$6.16	0.00%	\$8.00	BUY
AOL Inc.	AOL	NYSE	\$21.94	0.00%	N/A	SELL
Boston Scientific	BSX	NYSE	\$6.99	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$11.66	6.09%	\$12.67	BUY
Maxim Integrated	MXIM	NASDAQ	\$26.14	3.21%	\$29.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$20.06	9.23%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$18.16	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$11.51	7.26%	N/A	BUY
Transocean	RIG	NYSE	\$79.99	0.00%	\$90.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$40.89	0.00%	N/A	BUY

* Prices as of Friday, February 4, 2011

** Yield represents all distributions during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.

*** Name and Ticker changed from HRPT (HRP--NYSE)

BUY, HOLD, SELL OR LIMIT IN BOLD INDICATES A CHANGE IN ACTION OR LIMIT

This table has live prices, charts & buy limits on our website: <http://www.soundadvice-newsletter.com>

The rising tide of home foreclosures began in 2007 as a symptom of faltering real estate markets across the country. But as the rising tide turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US and worldwide economies. Indeed, the state of the nation's real estate markets and the economy have become one and the same. Clearly, the recession cannot be fully put behind us and a recovery kick into full gear until the inventory of foreclosed homes stops overhanging the market.

We have seen all this before. It was back in the 1980s. After years of loose and questionable lending practices, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate onto an already-depressed real estate market. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts. The crash was worse in some parts of the country, but the damage to the whole US economy was substantial. Does this sound familiar?

We have the same situation today. It's like the old good news/bad news jokes, except this is no laughing matter. The bad news is that today's crash has been damaging, to both real estate prices and the national economy.

The good news is that we have the tools to determine when the bad news will be over. This will give us a tremendous opportunity to not only invest in real estate for pennies on the dollar at the right time, but also in other investments as well that benefit from a recovering economy.

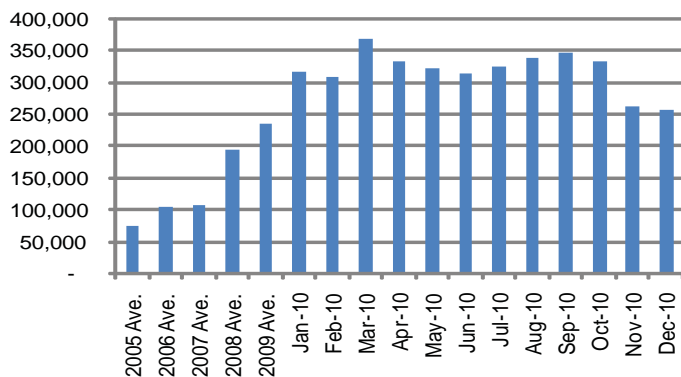
The Key Indicator

The secret is to focus on foreclosure rates. Fortunately, Realty Trac in Irvine California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We present some of their data here to gauge the state of the nation and its real estate, and plan to continue to do so in future issues of **SoundAdvice**.

Take a look at the chart below on US foreclosure rates.

In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by the time January 2010

US Foreclosure Rates
Monthly Averages



Source: Realty Trac

rolled around, foreclosures climbed to over 300,000 per month, and foreclosures continued to persist over 300,000 each month through October.

What we are looking for is a significant decline in the number of foreclosures. When this happens, the bulk of the overhanging inventory of foreclosed properties will have been digested, and the recovery can then begin in real estate as well as the economy. In the late 1980s, this was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began. For nearly two decades, fortunes were made from real estate purchased for pennies on the dollar during the S&L Crises of the 1980s.

There was a slight decline of 1.8 percent in December, – the latest data available, which followed a 21 percent drop in November. We know that there was a foreclosure freeze in October by Bank of America that began on October 8th and which continued through most of the month on 102,000 foreclosure actions. JP Morgan Chase also had a freeze on 56,000 actions. The GMAC unit of Ally Financial also had a freeze during the month.

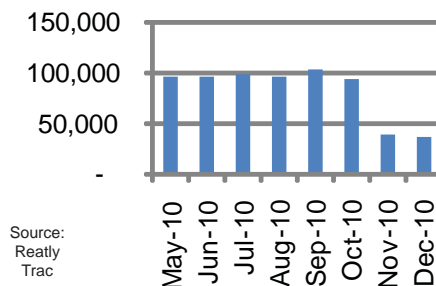
That freeze had lingering effects in November and December due to the lead time involved in gearing up again. In addition, the seasonal trend in recent years is for November and December to decline. So the majority of the decline during November and December could be explained by seasonal factors and by the foreclosure freeze. The real test will come in January. Predictions are that the first quarter of next year will see high foreclosure rates. If so, a significant downtrend will not have been kicked off by the recent 3-month decline. Otherwise, we are now seeing the beginning of the end of the crisis.

While foreclosure rates are a leading indicator, we believe that some of the data that goes into compiling the foreclosure rates has even better predictive value. This is because the number of foreclosures is measured by adding up the properties in each of the three stages of the foreclosure process: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. Because the first stage, new default filings, is the first step in the foreclosure process, it should therefore be an early indicator of a change in trends.

This chart shows new US default filings by month for the last seven months.

October showed a 9 percent decline followed by a whopping 58 percent decline in November, and a 7 percent decline in December. These are much larger declines than for foreclosures as

US New Default Notices



Source: Realty Trac

a whole, which could be expected from a leading indicator. Again, seasonal factors and the freeze could be most of the explanation. We will be keeping a close eye on new default filings in the months directly ahead.

Where are the Foreclosures?

While the foreclosure crisis is a nationwide problem, the bulk of foreclosed properties are not evenly scattered across the country. The table below shows where 68 percent of the 262,339 foreclosed properties were in November.

Foreclosure Activity - December 2010

	Number of Properties	Percent of Total	One in every	Monthly Change
US	257,747	100.0%	501	-1.8%
CA	65,915	25.6%	203	14.9%
FL	25,641	9.9%	343	-22.2%
MI	16,061	6.2%	282	4.9%
IL	14,042	5.4%	376	8.5%
AZ	13,561	5.3%	201	30.6%
NV	13,472	5.2%	84	18.5%
TX	11,162	4.3%	860	-16.5%
GA	11,042	4.3%	365	-23.4%
OH	10,523	4.1%	483	0.6%

More than a third of all foreclosures were in California and Florida. Adding the next seven states accounts for 70.4 percent of all foreclosures.

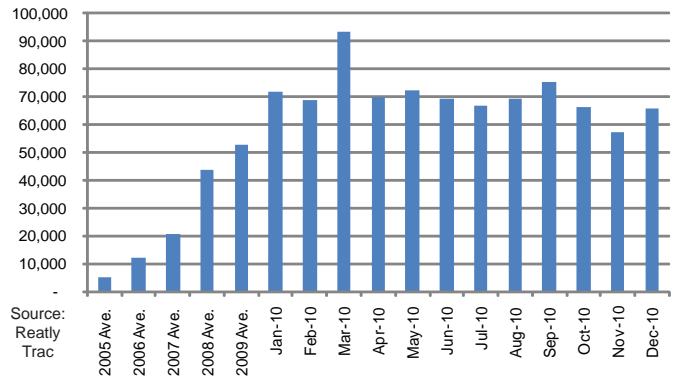
Nevada (NV) has earned a reputation as the foreclosure capital. That is because it has the highest number of foreclosures in relation to the number of houses there. The table shows that 1 of every 84 houses was foreclosed upon in December, which is the highest concentration of foreclosures in the nation. While that may be important to a homeowner or real estate investor in Nevada, other states are a larger burden on the national economy, notably California, and then Florida as a distant second place.

We need to keep an eye on California and Florida. Any changes in foreclosure trends in these two states should lead to changes for the national economy as a whole. Take a look at the chart of California Foreclosures - Monthly Averages.

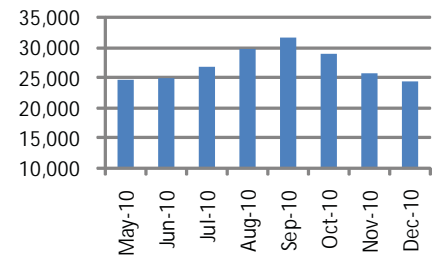
In 2005, foreclosures averaged 5,138 properties in California. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. After dropping 12 percent in October and another 14 percent in November, California foreclosures increased 15 percent in December, which is not an encouraging sign. However, new default notices in California declined by 6 percent in December after declining 11 percent in November and 9 percent in October.

Florida Foreclosures climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the rate dropped sharply by 42 percent in November, and then again by 22 percent in December. New default notices did not decline in October but plunged 52 percent in November,

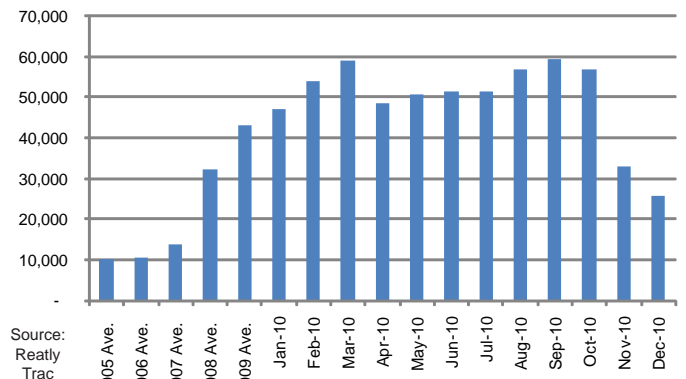
California Foreclosures - Monthly Averages



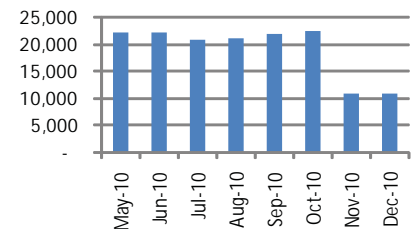
California New Default Notices



Florida Foreclosures - Monthly Averages



Florida New Default Notices



and by 0.8 percent in December.

Conclusions

The first quarter of next year will reveal whether the last two months of 2010 have been the beginning of a significant decline, or whether that decline reflects only the foreclosure freeze and seasonal factors. We will be tracking these foreclosure metrics closely in these pages of **SoundAdvice** to be among the first to know when the end of the foreclosure crisis is at hand. That will mean you can make enormous profits in real estate, as well as other investments that benefit from a robust economic recovery. Stay tuned.

Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool a "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the Risk Indicator will rise over the line

marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$7,709,294 in stocks and to \$1,284,574 in houses.

But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$306,412,776, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying the REITs. Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, Real Estate Investment Trust shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.52. This reading reveals that stocks are slightly above their average relative to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the **Sound Advice** Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be 1.5/3 or 50 percent.

When the Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators would hit zero in March, and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that

signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. The current reading is 25 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 16.7 percent.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual average return of 23.2 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent during caution periods.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the SoundAdvice Diffusion Indexes and their track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)

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