



The *Wall Street Journal* carried an off-beat story about how Wall Street is using human lie detectors, professional investigators trained to catch criminals and terrorists when they are lying. Now they are being hired to do the same when firms are interviewing prospective money managers. The problem, as one interrogator observed, is that "People on Wall Street are better liars.... more self-aware than common criminals or terrorists and thus more skilled at covering up their deceptions." After Enron's Ken Lay, Worldcom's Bernie Ebbers, Countrywide's Angelo Mozillo and, of course, Bernie Madoff, this hardly comes as news.

What made me laugh was the same interrogator's follow-up: "many honest investment professionals have behaviors that point to narcissism, a trait that often goes hand-in-hand with deception... an inflated sense of self isn't a suspicious anomaly on Wall Street." But why shouldn't those insightful and effective Wall Streeters have an exalted view of their worth? Aren't they paid princely sums for making brilliant investment decisions that make not just them but their clients rich?

Consider hedge fund managers, who commonly charge 2% of assets plus 20% of profits. The hook for new clients is that you are special and that not everyone can qualify to participate. As for the fees, extraordinary costs are justified by the projected extraordinary returns.

Perhaps. But what if their results could be obtained by flipping a coin? A recent Ibbotson study suggests that over the last decade, a period filled with volatility that insightful money managers should have been able to exploit, hedge funds provided no more benefit than did an investment in an S&P 500 index fund. To be sure, Wall Streeters talk a better game and wear much more expensive suits than do the folks at Vanguard, but they hardly earn their rich fees. But don't expect these narcissists to acknowledge that truth..

-Gray Emerson Cardiff

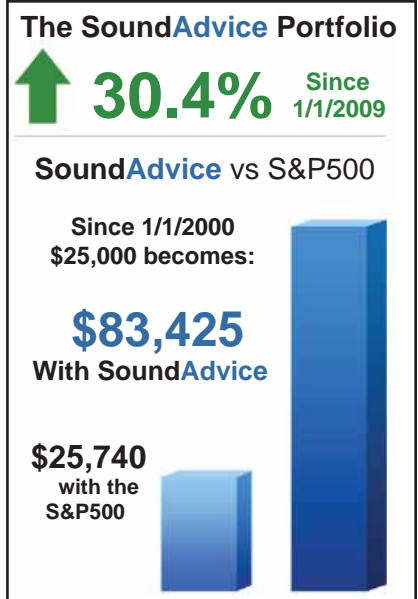
Closing the Book on 2010

It's time to close the book on 2010, a better year than most expected. Note that the prices and performance data used here will differ from the figures in the Update section, since those track prices through January 7th while these prices cover calendar year 2010.

Remember when the average investor, giddy with tech-fueled share prices as the new millennium began, considered 27% growth a feasible annual target? Remember when Warren Buffet after the 2000-2002 market meltdown proposed 7% as a reasonable annualized average expectation for equities in the coming decade? Buffet's 7%, derided even in the midst of a bear market as being too skinny, has failed to materialize (had he been right, the Wilshire 5000 today would stand about 25% higher than it is) and those who expected to double their portfolio's value every three years most got even worse news. It's likely this sort of investor has abandoned the market, and is now convinced that it can't be beaten. Those out of the market for 2010, as they did in 2009, missed a very good year. The Dow increased 11%, the S&P 500 12.9%, the pan-market Wilshire 5000 15.6% and the tech-centric Nasdaq led them all with a 17.4% gain. The *Sound Advice* portfolio grew 17.5%.

2009, once we got beyond the March low (but getting to that point was a doozy), was a relatively easy bull run with only a weak stretch between mid-June and early July. 2010 was a much more difficult proposition with significant reversals that tested the resolve even of optimists: mid- January through early February, May, June, August and November all challenged investor confidence. Both years, however, had this in common: individual investors boycotted the stock market: the average investor in 2009 shunned equities not only because most still were traumatized by their stock portfolios losing half their value in 2008 but also because headlines continued to waft a stench from Wall Street onto Main Street. Whether it was the still unfolding Madoff scandal, the absence of significant civil to say nothing of criminal proceedings against those responsible for the sub-prime debacle, the Flash Crash that tumbled share prices and mocked any sense of an orderly market or other proof that Wall Street serves itself first, the individual investor was absent, preferring to remain in cash or Treasuries regardless of the paltry yields these offered. No one seemed confident enough to get into the market until the public was certain the worst was over.

There were plenty of worrisome questions that made it hard to be in the market. Would the U.S. economy, whose recovery was tepid, slide back into recession, the dread Double Dip? Would the weapons deployed in late 2008 and 2009 against the near-collapse of global banking and stimulus measures designed to counter a deep recession generate massive inflation and/or ruin the dollar? Were the convulsions in European



economies not just destabilizing there and also around the globe but perhaps harbingers of what could happen here? Would China tighten its accommodative monetary policies to ward off inflation and what would that do to a fragile global recovery? None of these concerns, even those that materialized, prevented the market from ending the year well into the black.

The Sound Advice Portfolio

If you had to guess which sectors did best this year, we suspect that most would point to gold, which did have a good year but hardly made the biggest contribution to our performance. The **USAA Precious Metals & Minerals Fund** added a total return of 36.7%, a solid year, which is better than diversified miner **Anglo American's** 17% or the 24.3% turned in by **Leucadia**, which though a holding company with a very diverse portfolio, has a dominant exposure to mining assets. **Fidelity Select Natural Gas Fund** limped along with natural gas, adding just 4.8%, while **EnCana**, a pure play on natural gas, which joined the portfolio only in December, has added 1.1%. **Plum Creek Timber** returned 2.7%. When real estate once again shows a pulse, PCL should do very well. The biggest winner among commodities has been **Agrium** (+40.1%), which benefitted not only from increasing demand for fertilizer but also from BHP Billiton's spurned proposal for Potash Industries, which pushed all fertilizer stocks upward.

We had three double-digit losers. The **ProShares UltraShort Lehman 20+ Treasuries ETF** declined 18.7% as investors and speculators flocked at every crisis to the seeming safe harbor of U.S. government debt and pushed rates lower, which the Fed further enhanced by putting as much pressure as it could to insure rates remained low. Paradoxically, the second round of Quantitative Easing, once it went into effect in early November, marked a turning point in rates, after which they rose and thus boosted this leveraged bet that rates would rise. **Transocean**, the ultra-deepwater driller at the center of the Gulf of Mexico well disaster, dropped 16.3% for the year but the damage is worse if you date its fall from destruction of the Deepwater Horizon on April 23rd. RIG won't shoulder a significant share of the damages, which we believe will fall to BP, which owned the well and contractually is obligated to indemnify Transocean should it be found liable. Wall Street still is penalizing RIG far too much. As is the case with another loser, **Boston Scientific** (-13.1%), we're buyers of both companies' shares on expectations of a strong recovery.

Compared to those three losers, we had 31 double-digit winners. Though the two best individual performers (**Odyssey Healthcare** [+70.4%], the hospice provider, and **Liberty Global** [+68.1%], the international cable network company) are gone (ODSY was acquired and we sold LBTYA last month), the best sector from top to bottom consisted of industrial companies, which are highly cyclical. As investors sense an improving economy, cyclicals are great to own. The **Ford Convertible Preferred** on a total return basis

rose 48.4% as not only did the underlying shares of Ford outperform but also had its dividend (\$3.25 annually) was restored and paid off the amount in arrears (\$5.08). **Fastenal**, which sells literally the nuts and bolts for American industry, grew 44.8%, neatly outperforming the general hardware sector as represented by Home Depot (+21.3%) or Lowe's (+7.5%). **Superior Industries**, which turns out wheels and rims for new car makers, primarily Ford, GM and Chrysler, grew 44.5%. **Honeywell**, which sprawls across everything from aeronautics to heating and cooling devices, moved up 39.4%, while **UPS**, part of the U.S. and global economies' infrastructure, added 30.1%. **Paychex**, the payroll services company, can be included here as well, since it is strongly cyclical. Introduced in the October issue, it's up 14.2%. The **PowerShares Water Resources Fund**, which aspires to being a sector fund exclusively focused on water but in reality still is an industrial fund that holds a small number of pure water plays but bulks up with industrial companies that have some exposure to water, is up 14.7%, about par for equities. **Tetra Tech** is close to being a pure play on water and a major position in the Water Resource Fund lost 2.2%, though it has made a robust recovery from its late summer low. TTEK continues to pull in new contracts, and though the construction and local government client base is currently in trouble, we think water pollution and growing global demand for potable water make Tetra Tech an inevitable beneficiary.

Technology and healthcare were mixed bags. Strong winners like **Xerox** (+40.2%), **Maxim Integrated** (+20.7%) were tempered by ho-hum single-digit losers like **Microsoft** (-5.5%) and **Symantec** (-7.7%). Double-digit risers like **Perrigo**, **Odyssey**, **Hambrecht & Quist Life Sciences** (+19.9%) and **UnitedHealth Group** (+18.7%) among healthcare were interspersed with losers like **Boston Scientific** and nearly flat performers like **Pfizer** and **Stryker**. **Johnson & Johnson** (+3.4%) was our most frustrating position, hit by one goof after another. REITs also presented a divergent picture. Ken Heebner's **CGM Realty Fund** added 27.3%, nicely outperforming its benchmark, while **Commonwealth REIT** (the old **HRPT Properties**) disappointed, adding only 4.8%. After outperforming its benchmarks through mid-April, CWH dropped with REITs in general and failed to recover when its peers did. Part of the lag is due to digestion of a large secondary offering of common shares, which finally seems to be settling down and part to the relative underperformance of office and light industrial REITs. The 2010 stars were lodging and apartment REITs, which we discuss in the main recommendation.

It was a good year for cable networks. As with internationally focused **Liberty Global**, **Comcast**, the domestic cable system, had a banner year, adding 33.8%, while two other communications investments **Telecom New Zealand** (+12.3%) and **GAMCO Global Telecommunications Fund** (+10.4%) did respectably.

But all that is now history, and we start anew. Our indicators remain positive for equities.

Renting Rather Than Owning

The glum data on foreclosures presented on pages 8-9 is valuable not just for real estate prices but also as a leading indicator of where the U.S. economy is going, since without a recovery in residential real estate, it's hard to understand how we can begin to restore confidence and commerce. That weakness, however, has given strength to apartment rentals, which bottomed at the end of 2009 and continue to surge. Rents are rising and residential real estate investment trusts have outpaced other REIT sectors to say nothing of the overall market. The question is: have apartment REITs had their day? The answer is no. We believe that among the 17 REITs in this sector, at least one, **Associated Estates Realty Corp (AEC—NYSE/Nasdaq)** is trading at a significant discount to its peers as measured by the value of its portfolio and its earnings which suggests that in addition to an above-average dividend (4.4%), the shares have the potential to appreciate.

The Real Estate Cycle

Ralph Block explains in his valuable book, *Investing in REITs* (3rd edition) how real estate prices and profits move in two cycles: the supply/demand cycle and the capital markets cycle. Often these two strands converge, as they did in the climactic 2007-2008 commercial real estate debacle. We can date the previous cycle's peak to 2006-2007, when lenders and investors fought to float deals at ever higher prices. The top in the apartment cycle occurred when Tishman-Speyer and Lehman teamed up to bid \$22.2 billion, the second largest REIT takeover in history, for Archstone-Smith, an apartment REIT. The bottom came in early 2009 and was marked by REIT bankruptcies and a selling panic.

After a bottom, there usually follows a period when occupancy rates firm, rents stabilize but new construction is scant. We're at that point now. Eventually prime properties fill, landlords start aggressively to raise rents and construction picks up. As recovery continues, rents, property prices and construction increase until we get to the next top, at which point there is too much capacity, prices are unsustainable and it all falls apart.

The silencing of home ownership's siren song (home ownership hit an all-time high of 69.1% in 2005Q1—it now stands at 66.9%) has had significant implications for the rental apartment market. It increased demand for rentals by making home ownership either unattractive and inaccessible. Apartment rental occupancy rates hit bottom in the last quarter of 2009 at 92%. Today, nationwide the rate is 93.4%.

As for supply, the same refusal by lenders to finance home purchases also affected lending for new multifamily construction. In 2009, the last year for which we have figures, the volume of new construction abruptly dried up. After averaging 208,000 new apartments annually between 2005 and 2008, new construction of buildings with 20 or more units plummeted in the next year to 72,000. For 2010 (we only have

data for the first half of the year) completions are moribund. The caveat is that the building boom that died in 2009 left a glut of new construction in some regions (Nevada, California and Florida especially), much of which is owned by overleveraged developers, which suggests some or even most must come to market at distressed prices.

As for capital allocation, Block's second dynamic for real estate, if lenders are not bankrolling new construction, investors dedicated to real estate are buying into the apartment sector, and general investors are warming to it as well. REITs have been able to issue new equity over the last year, another sign of investor favor. As for valuations and property prices across the apartment sector, we're not close to the silly part of the cycle, which Tishman-Speyer and its partners marked out.

It's still not a bad time to buy into apartment REITs.

Associated Estates

Associated Estates is a smallish fish in the apartment REIT pond. With a market cap of \$635 million, it's dwarfed by big names like Equity Residential (\$14.3 billion), AvalonBay (\$9.3 billion) and UDR (\$4.1 billion). Even after AEC's shares outperformed those of most other residential REITs, the underlying value of its portfolio remains the cheapest in the sector. Based on data reported for

the most recent quarter, we calculate that AEC trades at the highest capitalization rate (unleveraged net operating income /value of portfolio) of 8.63% versus 6.55% for its peers. Its dividend yield stands at 4.4%, higher than any other apartment REIT.

The table on page 4 lists several REITs whose real estate portfolios are comprised mainly of apartments. The column titled "Stock Market Cap Rate" is revealing. The most widely accepted measure of real estate value is called a "capitalization rate", or cap rate for short. A cap rate measures the cash yield of real property assuming it is owed free of any mortgages. We have dissected each of these apartment REITs to see the value the stock price is putting on the underlying portfolio of apartments. Our analysis starts with the market value of the entire REIT (the current price of the stock multiplied by the number of shares outstanding). We then back out all of the other assets and liabilities to arrive at the value of the REITs' real estate portfolio. We then determine the net operating rental income (NOI) of the portfolio (gross rental income after deducting operating expenses). Finally, we arrive at the Stock Market Cap Rate by dividing the NOI by value of the real estate portfolio. The result we call the "Stock Market Cap Rate" because this is the cap rate that the price of the REIT's stock is putting on the REITs portfolio.

From an income perspective, AEC also is cheap, but remember, real estate cannot be treated in the same way as other businesses. Real Estate, because depreciation plays such a large role in how it accounts for earnings, is

Why does AEC trade at a higher yield, at a low Price/FFO ratio and why is its cap rate out of line with its peers'? In part, it has to do with the REIT's modest market cap...It might reflect concern that AEC has 48% of units in Midwestern buildings...Lastly, the market might remember where AEC began...and is not crediting the REIT for how it has changed.

Apartment REITS - Stock Market Cap Rates

	Symbol	Stock Price	Stock Market Cap Rate	Discount (-) Premium (+)
American Campus Communities	ACC	31.12	6.62%	-1.5%
Associated Estates Realty	AEC	15.41	8.63%	-30.9%
Avalon Bay	AVB	109.16	5.12%	34.1%
BRE Properties	BRE	42.50	5.04%	60.2%
Camden Property Trust	CPT	53.56	6.48%	1.7%
Equity Residential	EQR	49.94	6.14%	10.2%
Home Properties	HME	53.51	8.24%	-33.9%
Mid America Apartments	MAA	61.79	6.86%	-6.7%
Post Properties	PPS	36.21	7.14%	-12.2%
United Dominion	UDR	22.73	5.25%	62.7%
Averages			6.55%	8.4%

The Stock Market Capitalization (Cap) Rate measures the valuation the REIT's current stock price is putting on its underlying real estate portfolio. The average stock market cap rate is currently 6.55%. The right hand column shows the Discount (-) or Premium (+) of each REITs portfolio as measured against the average.

best measured not by GAAP earnings but by Funds From Operations (FFO), which are calculated by starting with GAAP earnings, then excluding gains or losses from debt restructuring and property sales and then restoring depreciation of real property. Adjustments are also made for unconsolidated entities such as joint ventures and partnerships. There are further complications, because how individual REITs calculate FFO is not uniform. For our purposes, we rely on statistics compiled by NAREIT, which place Associated Estates toward the cheap end of the Price/FFO range for 2010 and at the very cheapest level for this year.

Why does AEC trade at a higher yield, at a low Price/FFO ratio and why is its cap rate out of line with its peers? In part, it has to do with the REIT's modest market cap, which discourages institutional investors from holding large positions. It might reflect concern that AEC has 48% of units in Midwestern buildings primarily in Ohio and Michigan, where unemployment is running at 9.9% and 12.4%. These are older buildings with an average age of 18 years. Lastly, the market might remember where AEC began, owning subsidized apartments, and is not crediting the REIT for how it has changed.

AEC over the last eight years methodically has upgraded its portfolio, both the types of residential properties it owns but also in its geographic orientation. If we go back to 2003, just as the CEO Jeffrey Friedman, whose family founded the company and during the 1970s specialized in government subsidized housing, announced a new strategic plan, we'd see that it owned or managed 109 properties (25,174 units) scattered over a dozen states. Of these, AEC owned either directly, through subsidiaries or had an ownership interest in 79 properties (72%) of which 13 (16%) represented "affordable," units, that is housing subsidized under Section 8 of the National Housing Act. All of these were in Ohio.

As for market-rate properties, 33 (56%) were in Ohio and another 14 (24%) were located elsewhere in the industrial Midwest, 11 of them in Michigan. Outside this concentrated core market, Associated owned another 11 properties inefficiently spread over six states (Maryland, Florida, Georgia, Texas,

Pennsylvania and North Carolina). The portfolio was weighted toward older properties that could not command premium rents.

Less Produces More

Things have changed. In its most recent SEC filings, AEC reports its portfolio has shrunk to 50 properties in seven states with 12,976 units, fewer than half of its inventory when its reform began. Between 2005 and 2009, AEC disposed of 31 properties with almost 7000 units, which mostly had been built in the 1970s, including all the subsidized units. Most of the sales were made during real estate's more buoyant years, whereas most of the new units were purchased during the current commercial real estate downturn. Though AEC

management readily concedes it did not foresee the 2008-2009 meltdown that engulfed commercial real estate, it was fortunate in when it did most of its selling and when it began to buy.

The current inventory's quality shows marked improvement. Over the same period, AEC acquired six properties with 2131 units that on average are six years old. Associated got these at below their cost of replacement. All are Class A and garner above-market rents. All have significantly higher operating margins than those that were sold off.

In a presentation late last year, AEC broke out by region its net rents and occupancy levels and compared them to prevailing rents and levels. Rents for all AEC properties stood at a 21.3% premium to the market with the highest variance from market rates in northeastern Ohio (+37.3%). Occupancy levels for Associated also were above market averages with the highest in the Midwest at 97.3% versus that market's 90.7%.

Thanks both to the dynamics of the current rental market and the improved quality of its properties, Associated is able to raise rents. In the last reported quarter (2010Q3), AEC increased new rents by 2.1% and rents for renewals by 3.1%. Vacancies remain small with overall occupancy at 96.5%. However, real estate is local, and these numbers obscure regional dynamics. The weak spot is the Southeast, which had a 93.8% occupancy rate with 2.6% revenue growth. In Florida and the Atlanta market, AEC is dealing with regional overcapacity, which required concessions to new tenants such as one or two months free rent. However, a surplus of apartments in these markets means Associated can upgrade its inventory at attractive prices, positioning itself for the future.

Associated has financed these acquisitions in part through proceeds from property sales and a renegotiated credit line, but it also has been able to bolster its balance sheet through the issuance of new shares. In 2010 there were three common share offerings: at the start of the year, AEC issued 5.175 million shares at \$11.10 each, which netted \$54.7 million that went to repay debt. In May, the company issued 9.2 million shares at \$13 and booked about \$114.3 million, which it earmarked

to retire all of its outstanding preferred shares. Finally, at the start of October, the company completed another 9.2 million share offering at \$13.60, which put \$119.6 million more on the balance sheet. In November, it negotiated a new credit line of \$250 million. Associated has been very successful in tapping the market's increasing appetite for apartment REITs.

Future Growth

Associated sees opportunities in Florida and Georgia even if those markets at present are weak. In addition, Associated likes Dallas, Nashville and, in particular, Virginia and the Washington DC metropolitan region. Reviewing recent purchases, the same qualities appear consistently: more upscale properties in built up suburban locations close to transportation, shopping

and other amenities that can be bought below replacement cost. During an interview with Bloomberg late last year, CEO Friedman characterized Associated's market niche as "the masses not the classes," noting that AEC's average monthly rent is around \$900. Though we're certain Friedman knows his current tenants, we suspect were he to be asked the same question five years from now, he'd provide a different answer that reflected a geographical shift out of the Midwest and a preference for newer, higher grade properties with higher rents. In the meantime, we can participate in this transition at prices that underestimate not just the current value of Associated's inventory but also the richer market this REIT is moving toward. We recommend buying AEC up to \$17.

Portfolio Updates

Since we priced the *Sound Advice* portfolio on December 10th, we are up 2.2% versus 2.3% for the Dow, 2.5% for the S&P 500, the Nasdaq the pan-market Wilshire. The December recommendation, **EnCana**, is up 0.6% after energy shares, especially oil companies', levitated as oil has broke above \$90 but then fell back as the new year began. Though we remain constructive about where we think both the economy and stocks are heading this year, we can't help but observe that our bullishness that kicked off in the March 2009 issue ("Approaching A Buy Signal") and which for almost the entire duration of this rally has been a distinctly minority view has now become fashionable. Not only has the tone of the Wall Street types appearing on CNBC become bullish but mutual fund inflows after nearly uniformly favoring bonds and rejecting stocks have reversed. Though some still like to worship the 'wisdom of crowds,' when it comes to how crowds invest, the only time the herd is right is in the midst of very long-lived rallies or prolonged bear markets. At inflection points and as the market begins to reverse itself, the crowd does what is conventional and loses money.

If we look at positions that as the year ended and investors were aligning their portfolios for 2011 diverged from how they performed in 2010, there are some interesting divergences, both to the up and the down sides. Since we had 40 positions that rose and only eight that fell, we have more divergences to the down side.

CarMax last year added 34.4% but since the last letter has dropped 8.7%, and is the worst performer for the month. Shares had been sliding(-12.2%) since reaching their high on December 20th despite the company reporting excellent results for the previous quarter. The only flaw was that analysts had projected an even better outcome. Since CarMax, the biggest seller of used cars in the country, is well positioned to benefit from an improving economy and has a business model that anticipates robust expansion in the future, we're treating this retreat as an opportunity to buy shares at a favorable price.

Xerox and **Mattel**, not siblings in any sense, acted like twins,

falling 5% after increasing 40% and 34% in 2010. There was zero news on Xerox. For MAT, if you read between the lines, Wall Street might expect a weaker than expected outcome for the last quarter. The CEO is "retiring" abruptly, while toy sales at Target and other mass-market retailers was mixed over the holidays. Add in that the shares got a boost when Carl Icahn revealed he had taken a relatively small (less than 1% of the common shares) stake, the shares might have been due to settle downward. Icahn has a history of forcing companies to shake loose short-term benefits and/or finding a buyer and his entry into a stock draws buyers initially.

On the better performance side of the ledger, **Microsoft** increased 4.6% after finishing last year down 5.4%. Among the 1990s tech mega darlings MSFT along with Intel have shown the least resilience. For most on Wall Street, MSFT is obsolete, a cash generator from its legacy Windows and Office software, but hardly an innovator. Admittedly with a market cap of \$240 billion, Microsoft won't be changed by a single product or even a major innovation. For the shares to prosper requires a change in market perception. Over the last decade, MSFT has more than tripled sales and profits, yet its shares trade at less than a quarter of its PE, which testifies as much to the foolishness of the tech bubble as it does about the current market's abhorrence of this cash-generating monster. Perhaps 2011 is when investors rediscover MSFT's virtues.

Transocean last year fell 16.3% as the shares became toxic following the Gulf of Mexico oil disaster. Since bottoming in June, RIG is up 75%, which still leaves it 18% below where it traded before the April event. Three themes are influencing the shares: first, as we observed immediately after the Deepwater Horizon exploded and sank, Transocean's contract with BP, the majority well owner and operator, clearly indemnifies RIG for almost everything that ensued, including environmental damage. RIG's insurance would be adequate to cover its own liabilities. The only wildcard was (and is) were Transocean to be found to have been grossly negligent, an outcome that as time has passed seems more

and more remote. The second factor is what new regulations and standards for the deepwater drilling industry will mean for operations and profits. That is still unclear, but it's safe to make two assumptions: first, regulation and costs will rise and second, drillers will pass those costs on to well owners, who in turn will pass them on to consumers. The third factor has been a resurgence in the price of oil, which will make it all the easier for well owners to pay drillers.

International Speedways, which operates tracks that feature NASCAR events popular among younger middle-income fans who've had to tighten their finances during the recession and the continuing fall in home prices, fell 8.7% last year but since the last letter has added 2.5%, continuing a recovery that began in November. NASCAR's audience on TV, which does not depend on being able to travel to an ISCA track and buy a ticket, has also softened, which suggests fans are losing interest. We're willing to wait for the economy to improve before reaching that conclusion. At current prices and valuations ISCA's appeal remains attractive.

Turning to shares that continue to move higher after turning in a solid 2010, **Agrium** tops the list, spurring 12.5% since the last letter as the entire fertilizer sector is on a tear, driven by immediate news of lower crop yields and further reaching concerns that demand in emerging markets for a better diet has altered demand fundamentally. Add in recurring acquisitions that bid up the prices for fertilizer companies and you have an explanation for why AGU has doubled since the sector bottomed in late 2008 while the S&P is up by only 50%.

Ford Preferred added another 5.9%, and finishing at \$54.27. We are getting very close to a share price for both the preferred and the common that would cause Ford to redeem the preferred at \$50 or convert it into the 2.8249 common shares each preferred represents, which at the current price of the common are valued at \$51.61. The only redeeming argument for continuing to hold the shares rather than sell and either reinvest the proceeds into Ford common or go elsewhere is the dividend, which, were you to back out the value of the underlying Ford common, results in an outrageous 122% yield ($\$3.25 / (\$54.27 - \$51.61[2.8249 * \$18.27])$). The Ford preferred has been a bonanza for our subscribers regardless of whether they bought in when we initially recommended it in the low \$30s or were they bold enough to buy it anywhere along the downward spiral as the share price plummeted into the single digits. We got the appreciation. We got the fat dividend, but now it's time to sell these shares.

Leucadia hasn't missed a beat over the last month, adding another 7.1% after a double-digit 2010. Though LUK has an eclectic portfolio, the market with justification has treated the holding company in the same way it treats mining companies, since Leucadia is overweight toward mining assets, primarily through its ownership in Inmet, to which it sold its Spanish copper mine, and in Fortescue, an Australian iron ore mining company. Inmet over the last quarter has leaped 35% as the price of copper has surged, and Fortescue is up 30%. But the performance of another major holding, Jeffries

Group, a brokerage company, shouldn't be discounted as a factor in LUK's performance. Jeffries is up 16.7% in the last quarter compared to the S&P 500's 10.2% run. Over the same period LUK has jumped 23.5%. Leucadia's genius is buying assets cheaply and then waiting for circumstances to revive the value of those assets, which is why we've had LUK in our portfolio twice and have included it in the Five for 2011 basket. We've been asked about whether the two principals, Steinberg and Cumming, are essential to the company's continuing success, and the answer is yes. Their contracts run through 2015. Maybe they will re-up because this is what they do, but it's also possible they won't. Unlike the retirement of Warren Buffett at Berkshire which would shake up shareholders and hit the share price, we believe, were Steinberg and Cumming to decide to call it a day that Leucadia would go into liquidation. Even if the daring duo in such a sale could not extract every penny of the potential their portfolio might yield, they'd produce a very, very fat final payday for shareholders.

Agrium, Leucadia, Transocean, all are tied to natural resources and hard assets, which in turn are underpinned by concerns over the value of the dollar. In its simplest form, hard assets, especially those the market denominates in dollars, without any consideration of those assets intrinsic value, move inversely to the dollar. The forces influencing the dollar fundamentally are tidal, but also reflect temporary atmospherics. The tidal aspect reflects money creation, national debt and investors' confidence in a government's stability. Given the debt creation over the last 12 years, some of it essential to counter the biggest economic contraction of our lifetimes, some of it required to avoid the worst outcomes of a banking crisis, some of it to pay for wars around the globe and all of it done without regard to how it would be paid for, the dollar's fall over the last few years is warranted and probably has further to go. The atmospherics involve equally imprudent fiscal policies that have put downward pressure on the Euro and other European currencies. We expect Europe won't let the sovereign debt issues of some of its weaker members unhinge the entire continent, which will allow the Euro to regain its strength against the dollar. Provided our take turns out and global economic recovery picks up speed, commodities should continue to prosper.

The quintessential answer to currency anxiety remains precious metals, especially gold. 2010 was another banner year, with prices piercing the \$1420 level, but lately gold and silver have slid backward. **USAA Precious Metals & Minerals Fund** had it not distributed \$4.61 in dividends and capital gains would have lost ground since the December letter as investors and speculators sold off their positions. Instead, on a total return basis USAGX added another 3.4%. The most probable reason for precious metals' weakness is a reduction in anxiety that the U.S. economy is likely to implode. We continue to get fitfully better news about hiring, productivity, demand for capital goods and consumer confidence. We're retaining USAGX because we think the tidal factor will trump these other influences, especially if sharper concerns over inflation replace deflation anxiety.

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.41	4.41%	\$17.00	BUY
CommonWealth REIT***	CWH	NYSE	\$25.99	7.70%	\$28.00	BUY
Telecom New Zealand	NZT	NYSE	\$8.20	9.60%	\$8.70	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$92.13	0.24%	\$95.00	BUY
CarMax	KMX	NYSE	\$31.53	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$26.75	2.31%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$22.70	1.44%	\$25.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$35.32	1.40%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$109.50	1.12%	N/A	BUY
Fastenal	FAST	NASDAQ	\$59.28	2.13%	\$65.00	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$54.27	7.28%	N/A	SELL
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$20.50	1.76%	N/A	BUY
Honeywell	HON	NYSE	\$54.30	2.23%	\$56.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$26.27	0.61%	\$28.00	BUY
Johnson & Johnson	JNJ	NYSE	\$62.60	3.45%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$30.22	0.83%	\$34.00	BUY
Mattel	MAT	NASDAQ	\$24.18	3.10%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$28.60	1.82%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$47.47	2.02%	\$54.00	BUY
Paychex	PAYX	NASDAQ	\$31.87	3.89%	\$35.00	BUY
Pfizer	PFE	NYSE	\$18.34	3.93%	\$21.00	BUY
Stryker Corp.	SYK	NYSE	\$54.32	1.10%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$20.75	3.08%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$23.76	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$53.07	1.82%	N/A	BUY
Time Warner	TWX	NYSE	\$33.30	2.52%	\$35.00	BUY
United Parcel	UPS	NYSE	\$72.15	2.61%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$38.45	1.30%	\$41.00	BUY
Wal-Mart Stores	WMT	NYSE	\$54.08	2.24%	\$60.00	BUY
Xerox	XRX	NYSE	\$11.30	1.52%	\$14.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$25.38	0.00%	\$28.00	BUY
EnCana	ECA	NYSE/TSE	\$28.70	2.79%	\$34.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.17%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$39.45	4.26%	\$42.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$18.79	0.55%	\$19.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$39.73	11.59%	N/A	BUY
Aggressive Growth						
AOL Inc.	AOL	NYSE	\$23.59	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$7.28	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	\$11.23	6.32%	\$12.21	BUY
Maxim Integrated	MXIM	NASDAQ	\$23.99	3.50%	\$25.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$19.48	9.51%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$17.55	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$11.32	7.38%	N/A	BUY
Transocean	RIG	NYSE	\$75.04	0.00%	\$85.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$38.34	0.00%	N/A	BUY

* Prices as of Friday, January 7, 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

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.

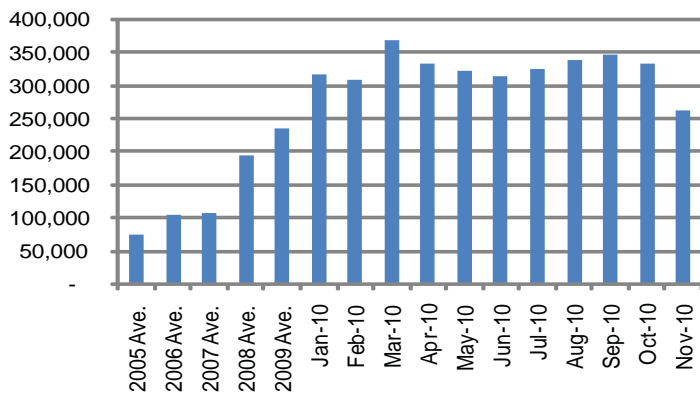
The Key Indicator

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.

As we can see from the chart, there was a 21 percent drop in November – the latest data available, which followed a slight decline in October. Is this the beginning of the decline we are looking for? It would be a good start if it were to last. However, 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.

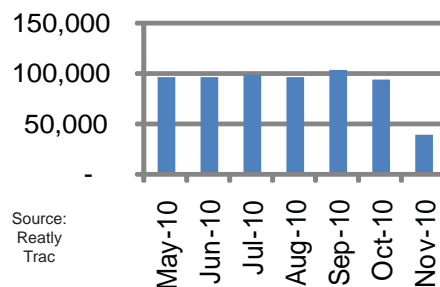
That freeze had lingering effects in November due to the lead time involved in gearing up again. In addition, the seasonal trend in recent years is for November to decline modestly (5% to 10%) from October. So the majority of November's decline could be explained by seasonal factors and by the foreclosure freeze. Since it would seem reasonable to expect December to be seasonally lower as well, 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 2-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

US New Default Notices



Source: Realty Trac

whopping 58 percent decline in November. These are much larger declines than for foreclosures as 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 - November 2010

	# Properties	% of Total	1 in every
US	262,339	100.0%	492
CA	57,378	21.9%	233
FL	32,938	12.6%	267
MI	15,311	5.8%	296
GA	14,423	5.5%	279
TX	13,369	5.1%	718
IL	12,941	4.9%	408
NV	11,371	4.3%	99
OH	10,458	4.0%	486
AZ	10,384	4.0%	262

More than a third of all foreclosures were in California and Florida. Adding the next seven states accounts for 68 percent of all foreclosures.

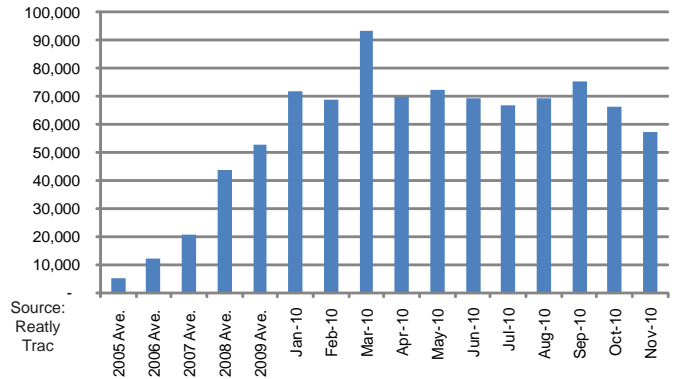
Nevada (NV) has earned a reputation as the foreclosure capital. That is because it has the highest number of foreclosures in relation to the number of houses there. The right hand column of the table shows that 1 of every 99 houses was foreclosed upon in November, which is the highest concentration of foreclosures in the nation. While that may be important to a homeowner or real estate investor in Nevada, other states are a much larger burden on the national economy, notably California and Florida.

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.

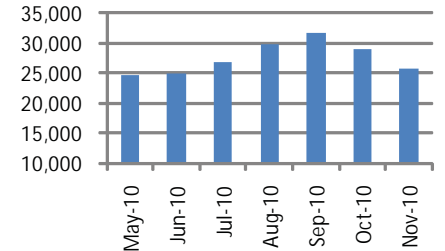
In 2005, foreclosures averaged 5,138 properties in California. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Both foreclosures and new default filings dropped 12 percent in October and 14 percent in November. California followed the national trend but did not decline as much in November as did the rates for the nation.

The situation in Florida was more dramatic in November. 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. New default notices did not decline in October but plunged 52 percent in November.

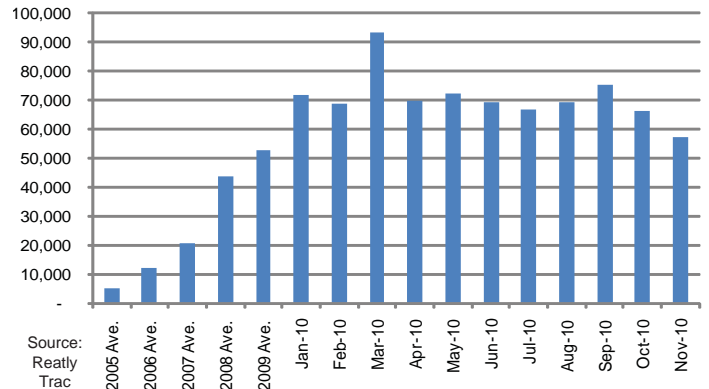
California Foreclosures - Monthly Averages



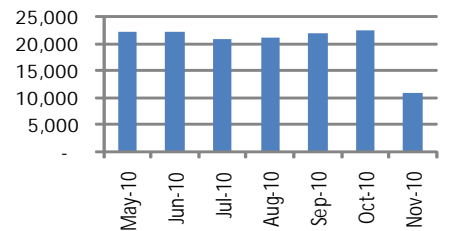
California New Default Notices



Florida Foreclosures - Monthly Averages



Florida New Default Notices



Conclusions

The first quarter of next year will be revealing. We will know whether the last two months have been the beginning of a significant decline, or whether it was from 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 \$7,408,000 in stocks and to \$1,070,745 in houses.

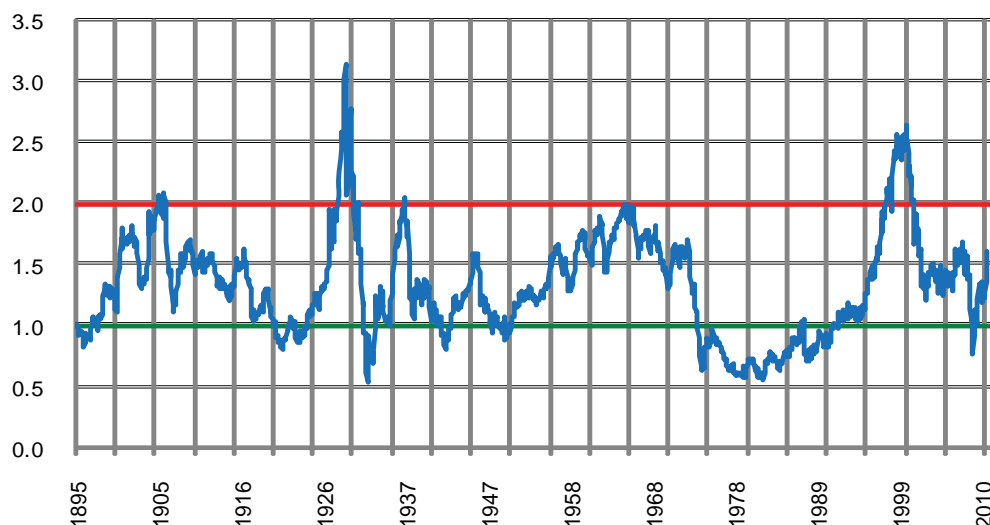
But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$297,299,277, or 39.7 times more money—the difference 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 1.62. 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 66.7 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 22.6 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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