

SOUND ADVICE

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Decades after my time as a broker, some clients still stick in my mind. One, who I dubbed the “dumb dodo” when he opened an account with a substantial check, the proceeds from a legal settlement, had one burning question: “Where is my money?” After I told him that the money was in a government money market fund, he wasn’t satisfied, and repeated his question. I finally realized that he wasn’t asking about what form his money was in but where his money was literally. He literally wanted me to show him the money.

There I was in my suit and tie, a sophisticated financial adviser who understood this particular client would require painfully detailed explanations at every step. Nothing would be too simple to skip the explanation.

That client’s face floated across my computer screen last week as news broke about the \$50 billion Madoff Ponzi story. Had Madoff’s clients been as insistent as my “dumb dodo” about where their money could be visited, they might have avoided what is unfolding. Better naïve than scammed. The truth is that most of us can be deceived, especially when we confuse trust with knowledge. Whether you rely on a broker, a mutual fund manager, a hedge fund hot shot, SEC filings, a financial journal or even a newsletter writer, everyone trusts someone to be vigilant for them. In Madoff’s case, his clockwork returns, in good markets and bad, lulled his clients, and reminds us to know why we trust another.

—Gray Emerson Cardiff

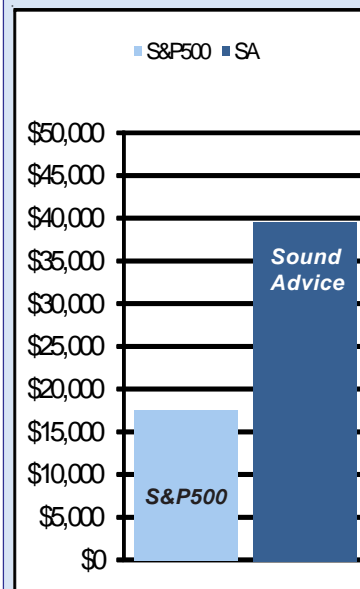
Still Waiting

The December 1st announcement from the National Bureau of Economic Research that the U.S. economy has been in recession since December 2007 had about as much shock value as hearing that it’s hot in hell. The only remarkable aspect is why it took so long, since the NBER says the U.S. economy had been contracting since December 2007. But the NBER never rushes to make such announcements, usually lagging the turns they call by anywhere from as few as five months (June 1980 mark of the January 1980 peak) to as many as 21 months (December 1992 mark of the March 1991 trough). In fact, the average lag for calling peaks, that is the start of a recession, has been eight months, notably shorter than the average 12.3 month lag for calling the start of an expansion. So, if the NBER’s cautious call fits the average lag, we might want to believe that by the start of 2009 we will have the low point behind us. Unfortunately there is nothing average about this recession. Not only is the world contending with the usual recessionary villains but we also are trying to lift our economies out of this ditch while our banking system is on life support.

Still, there is no doubt that stock prices will start to move higher well before the NBER calls the end of the recession, or for that matter, well before the recession itself does end. Markets tend to anticipate events, not successfully every time however. Wall Street wise guys mock economists, noting that economists have predicted 10 of the last three recessions. Economists can respond by noting that Wall Street pundits have predicted 10 of the last three bull markets.

If our argument sounds familiar it should. In May, we wrote

Sound Advice Versus the S&P 500



Since 1-1-2000, an Investment of \$25,000 becomes: \$17,471 with the S&P 500, for a loss of \$7,529, or \$39,507 with *Sound Advice*, for a gain of \$14,507, a difference of \$22,305 (88 percent of the investment)

optimistically about the NBER's lag, and suggested that despite the lack of a recession call, we could very well already be in recession. In a combination of Chicken Little and Pollyanna, we suggested if that were true, then, the market shortly could begin to sense a turn and begin moving higher. Well, that was almost seven months ago, and we are still waiting.

We can deal with how markets mark down the prices and values of companies during recessions or in response to company-specific events, but we have trouble understanding how markets act when the forces have nothing to do with valuations or prices. Consider how REITs are being mauled in the current market. Much of the pain derives from concerns anyone would have during a recession. But there are other forces at play that have nothing or very little to do with these shares' fundamentals. Nonetheless, they do hammer share prices. As aggravating (and expensive) such moves are, they can offer extraordinary opportunities.

In recent years during the bull market in REITs, almost all closed-end REIT funds (CEFs) used leverage to magnify their income and gains. As long as REIT prices were moving up and the costs of borrowing (usually through Auction Rate Preferreds [ARPs]) were less than what the common and preferred REIT shares yielded, CEFs were able to sweeten their returns. However, when the credit crunch and the oncoming recession sparked a tumbling REIT market, these CEFs eventually found themselves in a deadly downward spiral. Among the terms of their loans used to finance additional shares, these CEFs promised to maintain a 2:1 ratio of equity to debt. Should the value of their portfolios decline below that ratio, they were obligated to buy back some of their debt to bring their portfolios back to that 2:1 ratio.

The growing problem became how to fund these buybacks. **DWS RREEF** (which runs two funds), initially said it would use a secured line of credit rather than sell shares. However, the funds abruptly switched direction, and announced they would use cash, which was somewhat disingenuous, since to raise cash the funds sold their portfolios to the walls.

In the relatively small world of REITs, when a dozen or so leveraged CEFs at the same time were forced to liquidate shares to raise the cash to reduce their leverage, the impact was profound. SRO, for example, had to sell \$350 million of its shares, which pales next to the \$2.3 billion in leverage that the various Cohen & Steers REIT CEFs had to cover.

The total in forced sales not only drove share prices for the disgorged assets lower but also attracted sharks. Short-sellers, put buyers, momentum players and the rest all fed off the hemorrhaging REIT sector. The extreme trading patterns added to the chaos. Watching REIT share prices fall was itself unnerving, but what most shook subscribers was the huge volatility. On any given day during the worst of the drop, a REIT like **HRP** could move by 40% or more—in either direction—during the last few minutes of trading as volume ballooned, often equaling or exceeding the number of shares traded from the open till that last hour.

These staggering moves resulted in part from market-close orders entered by index funds, traders and momentum players, some of them huge in size, with the express intention of forcing the closing price up or down as suited their purposes. And without the uptick rule in place that in the past had prevented those shorting stocks from piling on by selling shares that were already declining, the mayhem was uncontrolled. This had absolutely nothing to do with anything as quaint as value.

The market now is attempting to right itself. REIT prices have rebounded, and perhaps in time we will see a market governed not by forced sales or game playing but by fundamentals. When does that happen? We would not hazard a guess.

Our selection of the **CGM Real Estate Fund** should position us well as the real estate market recovers. As we explain starting on Page 3, Ken Heebner has had a remarkable run, making more during good times than he loses in bad. For the first time in three years, his real estate fund has refocused itself back to REITs, a suggestion that one of the market's most successful and contrarian investors thinks better times are ahead for commercial real estate. **SA**

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Heebner Cycles

Invariably as an investor you make decisions for the very best reasons that you come to regret. This month's recommendation, **CGM Real Estate Fund (CGMRX)**, was a premature but profitable sell at the end of 2003, a decision we reached after the fund manager, Kenneth Heebner (AKA The Mad Bomber—more about that later) in our opinion at the time went off the rails, and morphed his REIT fund into a homebuilders fund that swapped REITs' traditionally high income component for a bet on growth. In November 2003, we recommended a sell, writing: "The **CGM Real Estate Fund**...hands-down outperformed every other REIT fund during the most recent REIT run," but worried that at some point Heebner's growth-oriented portfolio would be his undoing: "[W]e can guarantee that the fund will tumble further than other real estate funds when the party ends.... Don't think that you've heard the last of CGMRX. At the bottom of the next Heebner Cycle, we'll climb back on board." We believe that time has arrived. His portfolio once again—or at least for the moment—is almost pure REITs and has fallen deeply in this miserable market.

We think that despised real estate shares are attractive not just because investors have abandoned the sector initially both because of the credit crunch and even more worrisome now, the recession, but especially because shares have been brutalized by forced trading (see the cover essay). Even after a brisk rally for the entire market but particularly for REITs that kicked off on November 21st, this still is a depressed asset. The "Heebner Cycle" hit what we hope was a bottom last month, and offers an attractive entry point. In October 2007, CGMRX reached a high adjusted for splits and distributions of \$32.62. As we close this issue, the fund is trading at \$14.89, and at one point during the November meltdown fell to \$10.74.

The financial media, even when Heebner has been at the top of his game, is uncomfortable with him. *Morningstar*, for example, though it gives this fund a five-star rating, uses words like "daredevil," "feast or famine," "bold" and "little room for error." His lumpy

results when he is hot attract scads of new cash from "investors" looking for a big hit and drive out the same types when he runs cold. Of course, this is rarely successful with any investment but is especially foolish when dealing with Heebner cycles.

KEN HEEBNER

Heebner started his mutual fund shop in 1981. CGMRX, his second of three funds, debuted in 1994. Successful performers on Wall Street attract (or cultivate) fawning media coverage, which when things fall apart still attract equally enthusiastic "how the mighty have fallen" coverage. Bill Miller, for instance, gained endless accolades for his consistently successful and highly cerebral approach to value investing, and is now the poster boy for faded glory. Heebner lately is getting panned as well. It comes with the territory.

The brilliant years were 2003, when CGMRX outperformed the S&P by 61% and the Dow Jones All REIT Index by 53% and 2007 when the fund outperformed by 29% and 52%. During the late 1990s bull market, particularly in 1998, CGMRX stumbled around, underperforming the S&P by 48% and the DJ REIT Index by 4%. The recent fat years to a great degree relied on non-REIT investments, even investments that require a creative imagination to put into a real estate fund. This year, the story is very different. CGMRX is down 39.1%, worse than the S&P and the Dow Jones REIT Index.

But don't conclude that Heebner's previous success was mere luck, or presume his performance going forward will fall back to the pack. Over his investment career, Heebner's down years have turned out to be launching pads for subsequent profits. Such a pattern of successful runs following on poor periods is common for value funds, which buy when the market is depressed, suffer in silence while the market stewes around, and then reap profits as their unappreciated positions regain Wall Street's respect.

This is not how Heebner operates. He rarely waits patiently for the market to validate his foresight. Rather his style is to apply a handful of themes to his portfolio,

Sound Advice on CGM Real Estate Fund

and requires relatively quick validation. His very best runs have resulted from being able to pivot from one successful contrarian idea to another. If you do buy this fund, do not buy it for a quick hit. As we learned after we sold back in 2003, whereas Heebner himself is definitely not a buy-and-hold guy, if you want to own any of his mutual funds, you need to be willing to buy and then hold on throughout each Heebner cycle.

HEEBNER'S METHOD

Unlike the rest of our funds, CGMRX when it comes to portfolio changes is very active, hyperactive might be a fairer description. In general, we value patience and abhor the costs heavy portfolio turnover deducts from performance. The turnover ratio for the fund over the last three years has been triple-digit, hitting 200% last year as Heebner switched themes. This trading style also generates significant short and long-term capital gains, which makes the fund a better candidate for tax-sheltered accounts, in which capital-gains distributions are neutral events. In any case, we are willing to accept the turnover because it is an integral part of how Heebner works.

We've paid close attention to Heebner since first recommending CGMRX in April 1994. He does not start from fundamentals, though numbers are important for his specific choices. Instead, he starts with a particular point of view that dictates how he will invest. He then applies that perspective by rigorously evaluating specific stocks. He is both a big picture and a small detail kind of investor.

For example, just after 9/11 with the economy in recession and the nation hunkered down, the Federal Reserve pushed short-term rates lower and lower, reaching 1% and kept them there for a year. At the end of 2001, as housing stocks appeared in the portfolio, Heebner noted that the low interest rate environment favored homebuilders. It was just that simple.

In 2005, when coal stocks first entered the portfolio, the Fed was raising interest rates, energy prices were

rising, and the market was concerned alternately about inflation or stagflation. Heebner was paying attention to Asia, China in particular, and global demand for raw materials. For the next two years, he poured funds into natural resource stocks, convinced that with interest rates relatively cheap, despite Fed rate increases to ward off inflation, they would soar. In 2007, Heebner decided REITs were too pricey, noting that Blackstone Group, a private equity investor, had overpaid when buying Equity Office Properties, the largest office REIT in America. He slashed his exposure to the entire sector just as the market loved real estate. "Contrarian" often appears next to Heebner's name.

HEEBNER'S HOT HAND TURNS COLD

Earlier this month, the *Wall Street Journal* described Heebner's latest contrarian move, buying financial services stocks in his CGM Focus

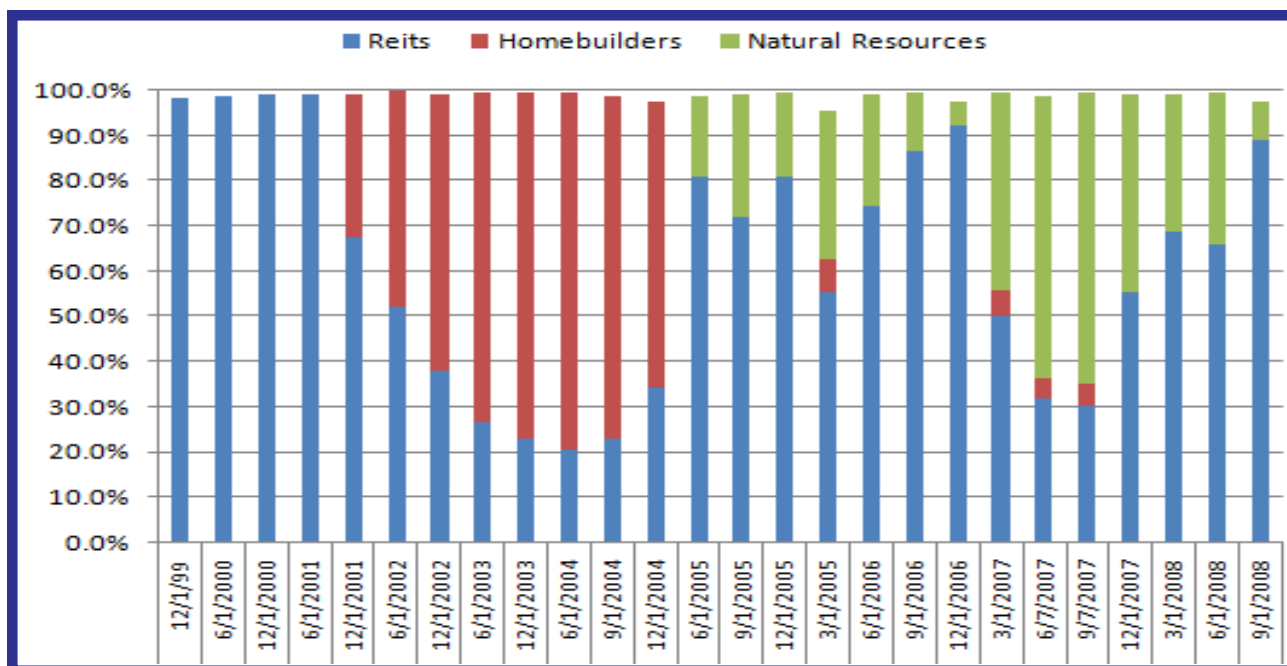
Fund. Last year it had soared (+80% versus the S&P +5.5%). This year results have been terrible for Heebner's funds, and not surprisingly Heebner has acted.

What is striking about Heebner's recent positive view of financial services stocks is that until he started buying financials he had been shorting names like Washington Mutual and IndyMac. Heebner explained his reversal: "A year from now, credit will be available because of the government's action." It's a simple observation—something anybody who reads the daily newspaper might conclude—but Heebner is willing to act, and act decisively, based on how he expects the economy to respond to that stimulus. If Heebner is right about financials' future, it's hardly surprising that he is making that same bet on REITs.

To glean what to expect going forward, let's take a closer look at the last seven years as Heebner purposefully changed his fund as often as Madonna changes costumes. At midyear 2001, Heebner was all REITs, but six months later homebuilders and building materials accounted for 31.5% of his holdings, a bias that topped out in mid-2004 at 79%, and at the end of that year still stood at 64%.

If you do buy this fund, do not buy it for a quick hit. As we learned after we sold back in 2003, whereas Heebner himself is definitely not a buy-and-hold guy, if you want to own any of his mutual funds, you need to be willing to buy and then hold on throughout each Heebner cycle.

CGMRX Portfolio Shifts: 2001-2008



The fund was swimming in profits and new money was pouring in from everywhere to take advantage of his play on builders, but Heebner was worried about the “funny money mortgages” then fueling real estate prices and his homebuilder positions. That worry triggered a radical change. Six months later, in June 2005, when CGMRX reported its portfolio, the fund’s exposure to home builders abruptly was zilch. Believe me, you can recognize a mania or a market distortion, but if it’s swelling your performance, you can find all sorts of reasons to justify not leaving the party. Heebner’s decision paid off. In the following month, residential construction stocks started their slide into oblivion.

What did appear in that same June 2005 portfolio was a new position in coal stocks (18%), which grew into a broader natural resources play that reached as high as 65% by September 2007. How do coal, copper or gold mining stocks get into a real estate fund? Look at the prospectus, which allows the manager to own hotel chains mining, lumber and paper companies, provided they have “significant real estate holdings.” We think Heebner stretched that in accumulating fertilizer company shares, which swelled his performance until the bottom fell out, but that’s another issue. The charter also allows him to put 20% of his assets into anything that he likes whether it is

equity, bonds or other securities regardless of sector. There is always that wildcard.

The fund’s expansion into natural resources was jagged as Heebner acted more like a trader, dropping the exposure to as little as 5.5% at the end of 2006, at which point he decided that overpriced REITs were less attractive than metals, coal and fertilizers. So he expanded natural resources and reduced REITs. For a time, as happened with his homebuilder trade, boosting his natural resource portfolio was brilliant, since REITs peaked early in 2007 while natural resource stocks would continue their run.

But after September 2007, Heebner once again detected a value imbalance between REITs and natural resources, and began to move back into real estate. As of this September 30th, only three coal companies, accounting for 8.5% of the portfolio, remain. The balance consists of REITs (86.1%) and a single real estate operating company (3%).

THE PORTFOLIO NOW

Saying that CGMRX is now committed to REITs really does not tell us much about how Heebner is weighting the various subsectors. Not surprisingly, he happily emphasizes what he expects will do well rather than what is doing well and ignores the rest.

Sound Advice: Portfolio Updates for December 2008

All REIT asset classes move up when the economy and market are moving higher, and suffer as a group when the economy and market suffer. However, each REIT class has its own dynamic. Apartment REITs do well when home owning loses its appeal, hotels soar during economic expansions and sour during slowdowns, retail does well when consumers are feeling flush, offices and industrial REITs prosper when business is expanding, mortgage REITs do well when people are buying homes or refinancing mortgages, while healthcare and storage properties fluctuate less, doing well if not spectacularly throughout the business cycle. Hence, healthcare and storage are defensive subsectors, just the place you want to be to preserve capital during a recession. Heebner, except when he moves to cash (CGMRX currently is 97.6% invested), does not play defense.

A chart published on our website just as the market hit its November low showed how REIT sectors had performed since the start of 2008 (<http://www.soundadvice-newsletter.com/pageViewArticle.aspx?id=e1bda3f3-29c3-4800-a80b-0e0f9116f137>). Losses ranged from hotels (-72.4%) to storage (-46.6%). Retail (-66.7%) and Industrial (-66.1%) were also weaker, while Healthcare (-54.1%), Residential (-57.8%) and Office (-58.3%) did "better," though not as well as Storage.

We suggested that the carnage was overdone, and that readers might start accumulating shares. Since then, REITs have widely outperformed both the S&P (+19.5%) and the XLF, the SPDR Financial Services ETF, (+37.3%). RWR, the REIT ETF, leaped 47.5%, more than double the S&P's rebound.

The most recent snapshot of CGMRX's portfolio dates from September 30th. At the time, Office and Industrial (24.8%) and Retail (30.9%) dominated. Apartments at 15% were also well represented. More significantly in terms of change from the previous report (June 30th), Apartment REITs had exploded elevenfold, while other subsectors rose by anywhere from a quarter to a third. Only Office and Industrial declined, down 13.3%. Heebner's emphasis on apartments suggests he thinks the housing sector will remain unattractive for the immediate future. The most intriguing change is a 32% bump up in retail, which presupposes a better economy and more consumer spending, or at least deems the damage done to these REITs exaggerated.

The \$64 question, which we won't be able to answer till the fund posts its year-end portfolio in February, is how Heebner has responded to the horrific punishment REITs absorbed between the end of September and November 20th. During these traumatic seven weeks, REITs' performance made the S&P's 36% collapse look mild. RWR, the REIT ETF, fell 60%, CGMRX 62%, while the REIT subsectors tumbled anywhere from declines in storage of 46% to hotel's 67%. The areas Heebner had expanded as of September 30th, apartments and retail, fell respectively 55% and 63%. If we had to guess, we'd say that Heebner increased his exposure to both, and might even be buying hotels. We base that not just on his track record but on his remarks, cited above, about where he thinks the U.S. credit markets and economy will be next year as they respond to the massive stimulation programs Washington has only begun to roll out.

SUMMARY

REITs until this decade were a relatively quiet and small part of equities, but thanks to their strong run since 2000 Wall Street has nearly tripled the number of funds dedicated to real estate. *Morningstar* counts 274 funds (that number is swelled when there are A,B or C shares as well as institutional funds not open to retail investors), of which only 8% carry their five-star rating. CGM Realty Fund is among that elite.

With the global economy in full blown recession, investors have bailed out on stocks and particularly on real estate, which is par for this part of the business cycle. Year-to-date, CGMRX compared to the other five-star funds sports the worst performance (-52%). Compared to all REIT funds it carries the best five-year performance. This divergence captures what anyone considering the fund faces. Fat years and skinny years. We think that Heebner, if you set aside the "Mad-Bomber" language, offers investors a shrewd contrarian's insights along with a gamblers willingness to put intuition into action. In a depressed REIT market, his fund can work for long-term investors willing to accept volatility in exchange for potential high returns. For a managed fund with this much turnover, the expense ratio (0.86) is significantly below the real estate fund average of 1.45. We expect the yield to rise over the current 2.67% as the emphasis on REITs kick in. We're making CGMRX an integral part of our portfolio. **SA**

Portofolio Upates

The market remains incredibly volatile, moved by big stories like the NBER finally declaring we've been in recession since December 2007, stunningly high unemployment figures, whether the US auto makers will get bailed out by Congress or the Treasury, how much more will be poured into the financial services sector to keep yet another institution from failing. We've long since become accustomed to market index moves of 3%, 4%, 5% and more, which make even the most seasoned investor wince and wonder what comes next. Our view remains that there are opportunities in this market, especially when prices are distorted by fear of what comes

next and anguish over what already has occurred. But it's hard to take advantage, since, we admit, there is no guarantee that tomorrow's prices won't be cheaper still. Speaking broadly, with Wall Street obsessed with macro issues and the potential for any blowup poleaxing the market, specific news for individual companies has little significance. At this point, perceptions and macro themes are all that count.

Since the November issue, *Sound Advice* is up 1.7%. As you recall, the November issue featured five ideas are primed for better-than-average performance over the next 12 months. **PowerShares Water Resources Fund** jumped 11.6%, **HRPT Properties Trust** 10.8%, **USAA Precious Metals & Minerals Fund** 15.1%, **Dodge & Cox Stock Fund** (1.92%) and **Johnson & Johnson** lost 4.7%.

If we look at the past month's tumultuous market through this quintet, we catch a glimpse of some of the forces surging through it.

Water treatment and remediation projects primarily are public works. Private industry also generates business for water-resource companies, but it is government that is the basic client. Though we don't cover the municipal bond market, there was abundant evidence that it shared all of the problems the general credit market did. Bond prices floored as investors fretted about not only whether bond issuers could cover their obligations and also whether the credit agencies that doled out robust ratings should have been trusted in the first place. The underlying problem in a shrinking economy is whether

towns, counties, states and private-purpose issuers had enough revenue to service their loans. Reflecting these concerns, a survey of water industry executives conducted in mid-October (<http://>

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www.changewave.com/freecontent/viewalliance.html?source=/freecontent/2008/11/will-recession-affect-water-supply-11-26-08.html) showed deep pessimism about spending around the world, especially by local and state governments. Barely a third of these industry insiders were optimistic. In presenting PHO, we recognized that governments instinctively defer infrastructure projects, even in good times, which is why we concluded that after decades of deferred maintenance and expansion that change was imminent. Even as the global economy slid into recession, which clearly threatened even existing levels of public financing, we noted that once a new administration arrived in Washington, especially if it was the Obama team, that any stimulus package would include infrastructure spending. It is now becoming clear that Washington will spend hundreds of billions of dollars to get the U.S. economy moving again, and much of it will go to states and cities to spend on just the sorts of things that PHO's portfolio of companies do.

That we can casually assume "hundreds of billions of dollars" will be authorized by the incoming Congress also helps explain why USAA Precious Metals & Minerals Fund soared. Gold, which is the core of this fund, despite dismissive treatment by central banks and market analysts, remains the ultimate safe harbor when financial seas are troubled. Since this spring, the dollar braked its downward spiral and has risen in value. With the credit crisis and recession swirling, U.S. Treasury securities surged as buyers drove prices higher and yield

Sound Advice Portfolio for December 2008

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
DWS RREEF Real Estate Fund II	SRO	AMEX	\$0.68	N/A****	\$0.95	BUY
HRPT Properties	HRP	NYSE	\$2.97	28.28%	\$4.00	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$30.30	0.36%	\$38.00	BUY
Boston Scientific	BSX	NYSE	\$7.17	0.00%	\$10.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$14.89	2.67%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$23.54	11.73%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$72.03	24.87%	N/A	BUY
Fastenal	FAST	NASDAQ	\$31.90	1.44%	\$40.00	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$14.98	1.55%	N/A	BUY
Honeywell	HON	NYSE	\$28.95	3.45%	\$34.00	BUY
Johnson & Johnson	JNJ	NYSE	\$57.25	3.21%	\$68.00	BUY
CarMax	KMX	NYSE	\$8.31	0.00%	\$12.00	BUY
Mattel	MAT	NYSE	\$14.60	5.14%	\$16.00	BUY
Microsoft	MSFT	NASDAQ	\$19.36	2.27%	\$26.00	BUY
Molson Coors Brewing	TAP	NYSE	\$45.58	1.80%	\$50.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$8.58	0.00%	\$11.50	BUY
Schering-Plough	SGP	NYSE	\$16.89	1.30%	\$21.00	BUY
Sprint Nextel	S	NYSE	\$1.96	5.10%	\$4.00	BUY
Superior Industries	SUP	NYSE	\$10.98	5.83%	\$15.00	BUY
Tetra Tech	TTEK	NASDAQ	\$21.59	0.00%	\$25.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$32.48	6.44%	N/A	BUY
United Parcel	UPS	NYSE	\$52.03	3.23%	\$60.00	BUY
UnitedHealth Group	UNH	NYSE	\$23.54	0.13%	\$27.00	BUY
Wal-Mart Stores	WMT	NYSE	\$54.63	1.23%	\$60.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$34.12	5.99%	N/A	BUY
Xerox	XRX	NYSE	\$7.75	2.06%	\$9.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUK	NASDAQ	\$11.30	10.00%	\$15.00	BUY
Icon Energy Fund	ICENX	800-764-0442	\$14.21	0.82%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$33.93	4.95%	\$41.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$13.75	0.50%	\$16.00	BUY
Transocean	RIG	NYSE	\$56.75	24.45%	\$75.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$17.58	15.07%	N/A	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	\$15.65	1.58%	\$18.00	BUY
Ford Motor Convertible Pfrd.	F.PRS	NYSE	\$9.61	33.82%	\$12.00	BUY
Icon Financial Fund	ICFSX	800-764-0442	\$5.40	1.70%	N/A	BUY
Liberty Global	LBTYA	NASDAQ	\$13.00	0.00%	\$20.00	BUY
Maxim Integrated	MXIM.PK	NASDAQ	\$12.82	1.89%	\$21.00	BUY
Federated Prudent Bear Fund***	BEARX	800-711-1848	\$6.88	19.48%	N/A	BUY
Symantec	SYMC	NASDAQ	\$12.49	0.00%	\$17.00	BUY
Time Warner	TWX	NYSE	\$10.03	2.19%	\$13.00	BUY
Western Digital	WDC	NYSE	\$12.52	0.00%	\$18.00	BUY

*Prices as of the market close on Friday, December 12, 2008

**Yield represents all income during previous 12 months divided by current share price.

Note that all fund distributions fluctuate annually.

***Note change in name for this fund

****Distribution To Be Reduced.

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

Sound Advice: Portfolio Updates for December 2008

to levels we've not seen in our lifetimes. For the shortest durations negative nominal rates occurred. Treasury note buyers effectively were willing to pay for the privileged certainty that their principal was guaranteed by the full faith and credit of the U.S. government. As that same Treasury churns out new securities to cover its trillions in bailouts, you would expect that interest rates should be rising. Instead, insatiable demand keeps forcing them lower. Contradicting market gravity eventually gets punished, and we expect that Treasuries and the dollar are setting themselves up for a vicious reversal. Perhaps that is what gold prices are predicting as well.

HRPT—and REITs in general—are also in a bizarre trading pattern. RWR, the REIT ETF, has traded since 2001. In that time, the 42 most volatile trading days all have occurred since Labor Day 2008. Even stranger, most of these price moves have hit in the hour before the market closed. We explore this in the cover essay. We think that REITs in general are trading without reference to the underlying value of their portfolios. We're not saying that every REIT should be bought, but we think that selectively they are grossly underpriced, especially the preferred shares of better REITs.

Dodge & Cox Stock Fund outperformed the S&P as financials and shares in general gained. But **Johnson & Johnson**, which we consider the stock owners can sleep most soundly with, fell. Why? Markets might not always be efficient but they are the best gauge of perceived risk. When risk is high, investors move toward more secure investments. Hence, JNJ, with a bulletproof balance sheet, businesses that do not dive during recessions and a global reach, is as safe as you can get, and when market fears peaked, unrisky JNJ was relatively attractive. Since November 20th, as investors bought back into the market, perceived risk ebbed, and JNJ lost ground relative to the S&P 500. Over time, we expect it will do fine.

Natural resource shares have had an extremely rough second half of the year. Peaking in July as oil hit \$147, across the board energy, mining, timber and other commodity prices have collapsed because the speculative frenzy that accompanied that rise subsided, but more importantly because investors have focused on a global recession, which means sharply lower demand for energy, metals, fertilizers and the rest. Also, speculators, who were reviled during the runup, should now be getting love letters from legislators and pundits who depicted them as the root cause for rocketing energy prices. Don't count on it.

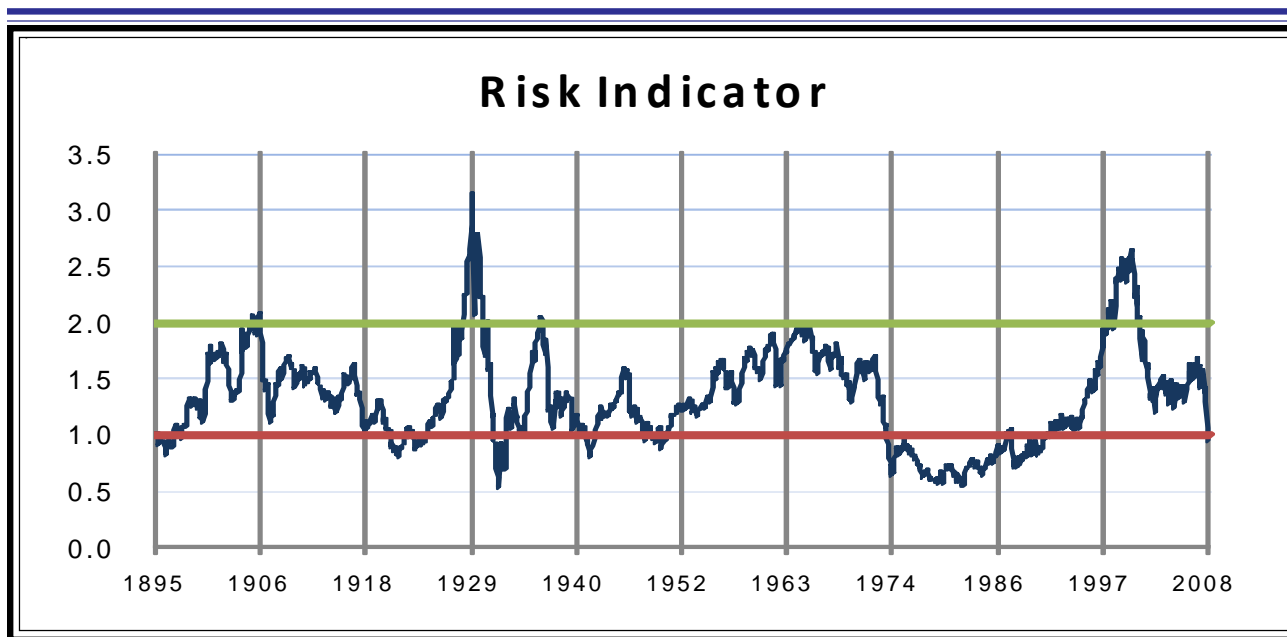
The Icon Energy Fund added 3.9% as the dollar again started to wobble. **Anglo American**, the mining

conglomerate, has been trimming production at its mines as demand slips, which convinced investors that demand would permanently remain impaired. Of course it won't. For the month, AAUK is up 18.6%. **Transocean**, whose core business is ultra deepwater drilling, like other energy service companies has seen its share price fall because investors expect lease rates to plummet as energy companies in response to lower oil and natural gas prices shrink their exploration and development budgets. How long will oil be priced in the low \$40s? As long as no one sees an end to global recession. Another factor this month that has undercut RIG is its removal from the S&P 500 and thus its forced sell from index funds because the S&P includes only companies domiciled in the U.S. As of December 18th, RIG will be domiciled in Switzerland. Since the last letter, RIG is off 19.6%. **Plum Creek**, the timber company, was flat.

Our view, simple as it may be, is that stimulus programs here, in Europe, Britain, China, India and elsewhere will jolt economies back to life. In the short run, demand from stimulus projects will put a floor under commodity prices, and, presuming the stimuli have the desired effect, renew normal demand for natural resources. The boost for all of these expectations will be a weakening dollar. **Ford** has been the least reviled of the not-so Big Three auto makers for two reasons. First, it does not need immediate cash from Washington because management had the foresight to line up financing when it was available, and second, its transition to more saleable vehicles is further advanced than at either GM or Chrysler. The preferred, since the last letter, has jumped 60.2%. From the start this has been a high-risk/high-reward proposition. Should Ford survive, these preferred shares will continue to pay what at the start was a very generous dividend and now is extreme, a reflection of how pessimistic investors have become about a positive outcome. Talk about perceived risk.

We are between earnings seasons, hard news about companies is scant, and yet stock prices seem to have a life of their own. Consider **Xerox**, which vaulted since the last letter 21.9% on no significant news. Just buyers seeing opportunities. Ditto for **United Health**, the health insurer, which is up 17.6%. The overriding fear surrounding medical care is that the Obama administration will push for national health care, which, according to the pessimists, means stingier payments. We think that expanding coverage to those without insurance will be a plus for the industry. If the past month's move has any meaning, perhaps the market is now reconsidering its earlier negativity. **SA**

Sound Advice Market Indicators for December 2008



The Risk Indicator measures the overall risk in the stock market by plotting the ratio of stock prices to home prices. See *The Science of Making Money in the Stock Market* for a full explanation of the Risk Indicator and the Diffusion Indexes.

The Risk Indicator is in historically low territory. At the S&P 500 low on November 13, 2008, the Risk Indicator dropped below 1.0 to 0.97. A reading this low reveals that stocks are historically low relative to house prices. This came at a time when both stock and house prices fell to new lows: The S&P to a low of 818.69, and median price of a new home a low of \$218,400. It is just that stock prices fell faster than house prices.

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. This Diffusion Index currently stands at 33 percent.

The Diffusion Index of Leading Indicators gives “Aggressive” signals when all four of its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

The next signal we are looking for is an “Aggressive” signal from the Diffusion Index of Leading Indicators. This Diffusion Index currently stands

at 25 percent. The only indicator that is still above its level of 6 months earlier is the indicator that measures the gap between the Federal Funds rate and the yield on 10-year Treasury bonds. The unusually large gap is indicative of an abnormal credit market - which is no surprise. Until we see a zero reading, we should remain cautious in our investing.

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 return of 17.5. 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 0.4 percent.

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

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