

## Scanning the Horizon



A down January has long thought to be a bad omen for the stock market. This January finished down 3.1 percent as measured by the S&P 500.

Known as the January Effect, the Stock Traders Almanac suggests that down Januaries are followed by substantial declines averaging 13 percent.

On the other hand, the January Effect predicts a 14 percent rise in the market when January is a positive month.

Our portfolio was up by 1.6 percent in January. If there is any credence in the January Effect, our portfolio will do well this year while the market will not.

While January tends to set the tone for the year, a lot can happen in the remaining eleven months. While there may be some statistical significance to the January Effect, there are notable exceptions -- too many to have much faith in the January Effect.

Still, we are off to a good start, especially in comparison to the market.

*-- Gray Emerson Cardiff*

In late January, Mario Draghi, the President of the European Central Bank (ECB), announced a massive quantitative easing (QE) program for the Euro zone. On a similar scale to the US QE program, the ECB will be flooding the Euro zone with €60 billion per month, beginning this March and extending to September 2016, totaling more than one trillion euros. This will have an impact on US markets in several ways.

Most importantly, Europe's QE program will stimulate growth across Europe, just as our QE program bailed out the US economy from its 2008-09 melt-down and fueled a 6-year recovery that is still going strong. An improving Euro zone economy will assist the US recovery through increased demand for our exports.

Initially, interest rates in Europe are bound to remain low as the ECB buys government and private sector bonds. The massive injection of euros is likely to cause the currency to remain weak which will boost growth because exports from Europe will be cheaper to the rest of the world. The other side of the coin is a strengthening dollar which makes US goods more expensive in Europe which will offset to some extent the boost in demand from Europe. Federal Reserve officials are not particularly worried about the effects of a strengthening dollar because exports only account for 13 percent of US output, and although a stronger dollar weighs on US exports, the negative effect is likely to be offset by lower energy prices.

For the next several months at least, all of this continues to support the bull market in stocks, which is being fueled by low inflation along with low interest rates, and the prospects of improving economies in the US, Japan (which has initiated its own QE), and China which has recently eased its credit conditions.

As the US economy continues to strengthen, along with recoveries elsewhere, there will be a time when US inflation will start to increase. This will be a game-changer because it will push up interest rates.

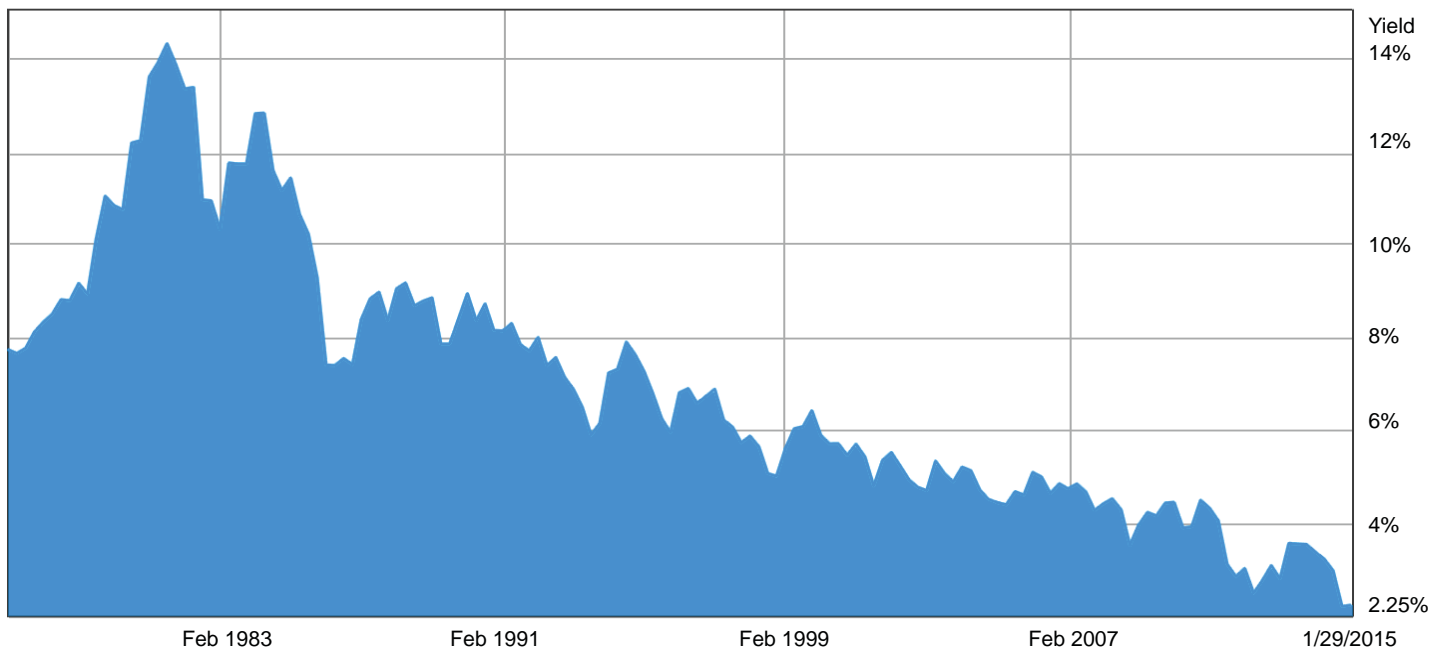
A few days ago it was reported that January consumer confidence was off the charts, up by 10.5 percent, the largest increase since August 2007. Consumer confidence is important because consumer spending accounts for two-thirds of the US GDP.

With stock prices relatively high and vulnerable, it is critical that we keep our eyes on the horizon for inflationary pressures. Keep in mind that the sharp drop in energy prices has been a primary factor in undermining inflation. However, downside movements of the price of oil from here are bound to be limited because the price is now substantially below the cost of production from shale which has been close to one-half US production and largely responsible for the recent glut.

Early signs of inflationary expectations will first be reflected in increases in long-term bond yields. Today's Treasury bond yields are historically low, even below the low point reached during the 2008-09 melt-down when the Fed lowered the Federal Funds rate to zero in an emergency to bail out the US economy.

Although the economy has been gaining strength for 6 years, the emergency

## 30-Year Treasury Bond Yields



monetary policy is still in force. The Federal Reserve acknowledges that it will be “normalizing” monetary policy by raising interest rates to normal levels.

The chart above shows the yields of long-term Treasury bonds over the last 30+ years. From this perspective, we can only conclude that the only significant room for movement is upward. The only question is how soon.

In the late-January meeting, the consensus among Federal Reserve officials is that employment growth is at a solid pace and job growth is strong. However, inflation declined further as market expectations declined and blamed “transitory” energy prices.

The Federal Reserve did not change its official forecast in the January meeting which projects that the Federal Funds rate will increase from zero currently by 2.5 percent by the end of 2016. What has become less clear is when the ascent would begin.

### New Swing Factor

In the late-January Federal Reserve meeting, a new “swing factor” was introduced by Fed officials: international development. The degree of success of the ECB’s QE program could change the Federal Reserve’s decision regarding normalizing interest rates.

What was once an indication that the normalization

process would begin in June, could actually begin in the fall or even not until 2016.

### The “No-Brainer” ETFs

Our reverse ETFs are designed to benefit from the inevitable rise in long-term Treasury bond yields. We have dubbed these ETFs as “No-Brainers” because interest rates always rise during an economic recovery. The ascent has never been smooth and this time has proved to be no exception. These ETFs differ in the amount of leverage used:

The [Direxion Daily 20 Plus Year Bear 3 Shares \(TMV\)](#) uses 3:1 leverage.

The [Proshares Ultrashort Lehman 20 Plus Year Treasury \(TBT\)](#) uses 2:1 leverage.

The [Proshares Short 20 Plus Year Treasury \(TBF\)](#) uses no leverage.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance.

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock’s iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds with an average maturity length of close to 27 years. The prices of our No-Brainer ETFs fluctuate in accordance with

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the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

As we have pointed out in past issues, the prices of these ETFs can erode over time because they decline slightly more than they increase with equivalent changes in bond yields. However, the erosion is minimal in comparison with changes caused by changes in bond yields.

We can project the movements of these ETFs based on the Federal Reserve's official forecast. Assuming Treasury bond yields will move in tandem with the Federal Funds rate, long-term Treasury bond yields will rise by 2.5 percentage points, from 2.25 percent today to 4.75 percent by the end of 2016.

This seems like a reasonable forecast because investors normally require a real return of 3 percent. As inflation returns to the Federal Reserve's target of 2 percent, long term Treasury bond yields should be in the vicinity of 5 percent. What is less predictable is what happens in the meantime.

A conservative forecast would be to assume that long-term Treasury bond yields continue declining throughout 2015, to a yield of 2.0 percent, and then increase to 4.75 percent by the end of 2016. Here is what would happen to each ETF:

TMV would decline to \$21 by the end of 2015, and then climb to \$84 by the end of 2016.

TBT would decline to \$35 by the end of 2015, and then climb to \$90 by the end of 2016.

TBF would decline to \$22 by the end of 2015, and then climb to \$35 by the end of 2016.

This forecast gives us perspective on the potential risks and rewards from here. However, financial markets rarely move gradually, or in an orderly fashion. It is highly unlikely that bond yields will rise in a gradual and orderly fashion once the first whiff of inflation permeates the markets. The most likely scenario is that trillions of dollars currently hiding in bonds will be scrambling for the exits. As the US economy continues to heat up, and other economies around the world start to show vitality, US inflation is bound to heat up. Fear will likely consume the US bond market and the rise in bond yields is likely to be faster and to higher levels than is projected currently. That is usually how it works.

At any rate, whether the rise is gentle or steep, we are bound to see substantial profits in these ETFs.

Although these ETFs deserve attention, they are only one of 24 positions in our model portfolio. However, the same macro forces, to which these ETFs are most sensitive, will be acting on the rest of our holdings as well.

### A New Real Estate Fund Recommendation

Choosing the best real estate mutual fund is not easy. There are 15+ no-load real estate funds from which to choose, and sorting them out is a project. We have done that

recently, and here are the results.

The first question is: Why invest in a real estate mutual fund, and why now?

Most of the time, above average investment returns can be earned. Over the last 10 years, real estate funds have outperformed the S&P 500.

Therefore, just finding the average real estate mutual fund will likely bring you investment returns that are superior and more reliable than the stock market over the long run. Moreover, at certain times, investment returns are exceptional from real estate funds, especially the funds that perform consistently better than the averages. We believe the months immediately ahead will be one of those times.

### The Big Cycle

We all know about business cycles and their impact on investments. However, the business cycle is particularly powerful on real estate because financing is typically employed. Not only does financing introduce leverage, but its availability and cost can either starve the market or pump it up. Often these cycles are long and span a generation, so the majority of investors do not remember or know about them.

During the economic expansion, the investment returns are excellent. First, for each 5 percent increase in rental income, net operating income (after operating expenses) increases by a larger percentage, from 7 to 10+ percent, depending on the type of real estate and level of expenses, because expenses are relatively fixed. Since the value of the real estate is measured by the net operating income, the value goes up sharply.

Not to get bogged down in too many numbers, but a brief illustration is important. A property with, say, \$120,000 in rental income and operating expenses of \$42,000 (35 percent of income), would have an annual net operating income of \$78,000. With capitalization rates at, say 6 percent, the value of the property is \$1,300,000 ( $\$78,000/0.06$ ). Let's say the mortgage is \$780,000 (60 percent of value), which leaves an equity of \$520,000.

Now, let's raise the rent by merely 5 percent. Assuming expenses increase 3 percent, the net operating income increases to \$82,470. At a 6 percent capitalization rate, the property is worth \$1,379,000. Subtracting the mortgage leaves equity of \$599,000. Note that this is a growth in equity of 15.2 percent, all from a mere 5 percent increase in rental income.

### Which is the Best?

The largest REIT mutual fund is the **Vanguard REIT Index Investor Fund (VGSIX)**. It is designed to represent the average of all real estate investment trusts (REITs), and it is the benchmark of the industry. Over the last 10 years ending in 2014, it has earned an average annual return of 9.31 percent versus 5.4 percent for the S&P 500. During 2014, it returned 32 percent versus 11.4 percent for the S&P 500.

## Annual Returns of Real Estate Funds

Fund Name	Symbol	10 Year	5 Year	3 Year	1 Year
ProFunds Real Estate UltraSector Investor	REPIX	20.44	20.44	21.35	41.86
SSgA Clarion Real Estate Institutional	SSREX	8.08	16.90	16.32	33.50
Managers Real Estate Securities	MRESX	10.21	17.58	16.62	33.33
Alpine Realty Income & Growth Institutional	AIGYX	7.28	17.83	17.36	33.31
DFA Real Estate Securities I	DFREX	9.03	17.54	16.76	32.99
Vanguard REIT Index Investor	VGSIX	9.31	17.38	16.80	32.01
Cohen & Steers Realty Shares	CSRSX	9.64	16.42	16.53	31.92
Fidelity Real Estate Investment	FRESX	8.85	17.50	16.57	31.90
American Century Real Estate Investor	REACX	8.54	17.93	16.42	31.64
Morgan Stanley Inst US Real Estate P	MUSDY	9.36	16.50	16.19	31.36
Forward Real Estate Investor	FFREX	7.15	15.73	16.72	29.73
Neuberger Berman Real Estate Trust	NBRFX	10.00	16.08	13.86	25.24
ASTON/Harrison Street Real Estate N	ARFCX	7.86	16.51	14.92	23.29
CGM Realty	CGMRX	12.37	13.69	13.36	21.48
Third Avenue Real Estate Value Investor	TVRVX	6.89	12.48	20.56	17.03
Average		9.67	16.70	16.69	30.04

Real estate is an asset class that can benefit from active management because various sectors take turns in performing better. In our continual quest to find the best investments possible, we recently surveyed the real estate mutual fund industry again to see if there would be a better investment.

The table above summarizes our results for the annual investment returns for 15 real estate mutual funds over the last 10 years, 5 years, 3 years, and 1 year. These funds are ranked based on their performance during the last year. The averages are also shown at the bottom.

During 2014, five funds performed better than the Vanguard REIT Index Fund. In 2013, several funds also did better. That was also true in prior years. The trouble is that the superior performers are not the same each year. It is a revolving door. Without a crystal ball, it is impractical to chase last year's winners because they seldom lead the pack in the following year. In fact, sometimes one year's leader is one of the worst performers the following year. However, VGSIX is always above the average because most funds do not do as well year in and year out.

Vanguard REIT Index is also one of the cheapest ways to invest in a broad array of REITs because of its low 0.10% expense ratio.

Accordingly, we are adding the **Vanguard REIT Index Investor Fund (VGSIX)** to our portfolio.

Although we are adding VGSIX to our portfolio this month, we are still keeping the **Third Avenue Real Estate Value Investor Fund (TVRVX)** because it is replete with stellar values substantially below NAV with strong growth prospects. It is up 2.5 percent this year, extending our profit to 21 percent. Although this fund out-performed the S&P 500 last year by a substantial margin in 2014, its performance was below the average REIT fund. In fact, you may have noticed that it is in last place on our table with its 17.03 percent

return (including a distribution of \$1.066 per share). However, TVRVX was in first place in 2013, which was not a simmering year for REITs. Because of its attention to value, TVRVX will shine during years when REITs in general do not. In case 2015 turns out to be one of those years, we will be glad we kept TVRVX.

The comparison of TVRVX to other REIT funds is not totally fair because TVRVX has a number of distinguishing characteristics. TVRVX is more of a global real estate fund, and as such, it has outperformed all of its global real estate competitors during the last three years.

Another distinguishing factor is that management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business.

Management also looks for opportunities in different points of a real estate company's capital structure by investing in senior debt in addition to a company's equity.

TVRVX also tends to be less volatile than the typical REIT fund because management will go to cash when asset prices are generally high. This tendency gives management opportunities to scoop up bargains in distressed times.

The Third Avenue management has a similar approach to ours because it is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams to come up with their estimates of intrinsic value. Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").

3) There is comprehensive disclosure including reliable audited financial statements.

4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

In the quest for value, Third Avenue management is also constantly assessing risk. As interest rates have fallen to historically low levels globally, the cash yields on real estate (capitalization rates) that investors are satisfied with have also fallen to record lows which has led to record high property prices in most major markets. In considering the likelihood of rising interest rates in the months and years ahead, management recently reduced its holdings of securities that have been bid up in price by yield-seeking investors, such as REITs whose tenants have long lease terms, increased holdings of well-financed companies trading at discounts to net asset value (NAV), real estate companies operating with shorter lease terms, such as apartments and hotels, as well as real estate-related companies that would earn higher profits in a higher interest rate environment, such as US banks.

Here are updates on the rest of our positions in alphabetical order:

## Portfolio Updates

**Agrium (AGU)** is up 9.4 percent this year, extending our profit to 659 percent. We include AGU in our portfolio because it has a broad mix of agricultural products and services that increases the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while worldwide population and per-capita income increases.

In January, Agrium said it would pay out 40 to 50 percent of its free cash flow as a dividend. Although the approximate dividend is not defined or estimated by the company, it is an increase from the 25 to 35 percent current target. The company also said it will be buying back up to 5 percent of its stock, close to 7.2 million shares, during the next 12 months.

**Associated Estates Realty Corp (AEC)** is up 11.6 percent this year, extending our gain to 86.8 percent. What originally attracted us to AEC was the fact that this high-quality apartment REIT was selling at a substantial discount to the value of its net assets.

Based on the price of apartment REITs, the market is currently paying an average capitalization (cap) rate of 4.75 percent for the underlying portfolio of apartment properties. If we value the AEC's apartment portfolio at a cap rate of 4.75 percent, the value translates into a value of \$33 for AEC. We have been using a more conservative valuation and target of \$28.50 per share. We began recommending AEC at \$15.40.

We have been watching it slowly move up while collecting a nice dividend.

It often takes the attention of an activist to unlock the value of a discounted stock. In this case the activist is the Land & Building Fund which has invested \$1.1 billion in AEC, and is looking to make a profit. CEO and founder, Jonathan Litt, announced he is launching a campaign to replace the board of AEC on the grounds that management has not been responsive to dialogues regarding unlocking shareholder value. The stock has been moving up since the day of the announcement.

We had a similar experience with Commonwealth REIT. We recommended it while it was also trading at a steep discount to the net asset value of its real estate. Activists went after that discount as well. After investing heavily in the REIT, they mounted a successful campaign to remove the board in a proxy fight. On the announcement and during the proxy battle, the stock climbed more than 50 percent to close to its net asset value, at which time we took our handsome profit.

**Boston Scientific (BSX)** is up 11.8 percent this year, extending our profit to 54 percent. BSX's medical products are well suited for an aging population in the US. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs.

**Chesapeake Energy (CHK)** is down 1.5 percent this year, trimming our gain to 20 percent. We originally added CHK to the portfolio because it was at a substantial discount to its net assets. The stock price was cheap because of low natural gas prices, poor corporate governance, and because it was in the midst of a financial squeeze. We could see all of these conditions were likely to be remedied, and indeed they were. Yet, we have another buying opportunity.

The market is forgetting that CHK is the second largest producer of natural gas, and that 70 percent of production volume comes from natural gas. Fracking for oil also produces natural gas as a by-product. A reduction in fracking for oil will also translate into a reduction of the supply of natural gas and bolster prices. With natural gas inventories currently below average levels, the market should remain steady. This benefit should help CHK weather the volatility in the oil markets.

In late December, Chesapeake finalized the \$5 billion sale of some of its assets outside of its core positions in the Marcellus and Utica shale. The company subsequently announced that it will use part of the proceeds to buy back one billion dollars of CHK.

**Fidelity Select Natural Gas Fund (FSNGX)** is down 5.5 percent this year, trimming our gain to 6.4 percent.

The precipitous drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial

disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$46 a barrel, that is the cost of 5.8 million BTUs. However, with a market price for natural gas close to \$3.00 for one million BTUs, 5.8 million BTUs will cost \$17.40 (5.8x\$3.00). So the same amount of energy is still available for 38 cents on the dollar, if it is in the form of natural gas rather than oil. This difference still translates into an expanding natural gas industry, which makes this fund continue to be attractive.

The chart to the right shows the historic relationship between the costs of these two forms of energy.

The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together recently, but remain substantially apart.

**Ford (F)** is down 5 percent this year, trimming our gain to 2.7 percent. The stock price close is close to 10 times 2014 earnings which were depressed because the new F-150 debut cost Ford about 13 weeks of production down time. Also dragging 2014 earnings was the preparation for 23 other vehicles that are either new or significantly refreshed. Ford's capital spending was close to \$7.5 billion in 2014 which was \$900 million more than in 2013.

In the final days of January, Ford reported earnings of 26 cents per share, 3 cents higher than expectations.

Growth prospects in 2015 look good for several reasons. Its all-aluminum F-150 truck is likely to set a new industry standard. It weighs 700 pounds less and is projected to get close to 30 miles to the gallon. The Company reports that sales are going "extremely well".

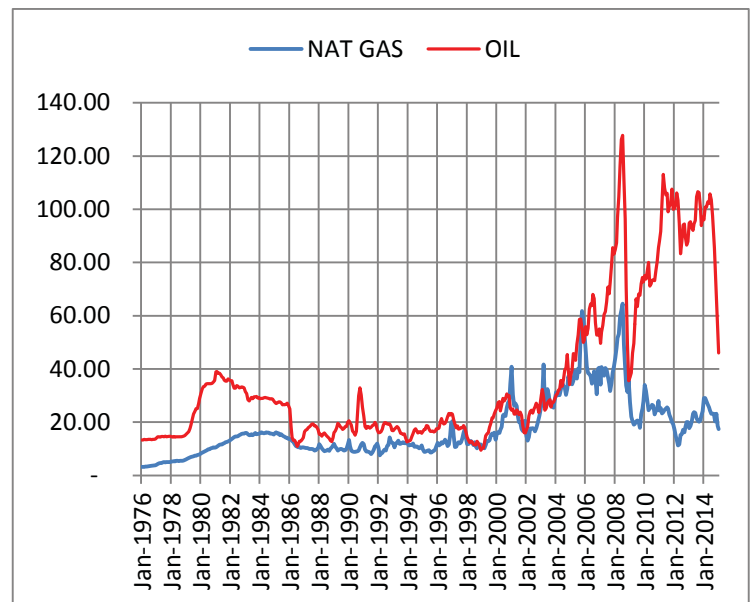
With the new F-150 trucks along with other new and innovative models, the stage is set for significant revenue growth this year. Ford's fuel-efficient models, the Fiesta, Focus, and Fusion, have been very well received and should continue to do well.

In addition, the US auto industry is subject to pent-up demand for the next several years because of an historically high abundance of older cars still on the road. Low interest rates and plentiful credit make it easy to buy. In addition, low gas prices are particularly good for Ford trucks.

Ford is also making significant cuts by reducing the number of platforms it uses to produce its models. The number of platforms is currently down to 15 from 27 in 2007. In 2016, Ford expects to have only 9 platforms, and the ultimate objective is 8 platforms. As a result of the reduction of platforms, development costs are dropping by billions of dollars through economies of scale, and Ford has the ability to adapt more quickly to changes in demand.

**Freeport-McMoRan Copper & Gold (FCX)** also suffered along with the general decline in energy stocks because a significant portion of its assets are now in oil through the

### The Cost of Energy Equivalents of Oil and Natural Gas



2013 acquisition of oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. FCX is still primarily a copper stock. In 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. The price of copper has also declined along with the general decline in all commodities. In the final days of January, FCX reported earnings of 25 cents per share, below expectations of 35 cents. The disappointment caused the stock price to drop to multi-year lows. The decline has turned what was once a hefty profit into a 39 percent loss. However, this condition is not a permanent situation. As economies expand around the globe, FCX will be a strong beneficiary.

Copper is woven into the fabric of the world's developed economies, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. As the world's economies continued to expand into 2008, so did FCX.

**Hersha Hospitality (HT)** has declined 4 percent this year, trimming our gain to 25 percent. Our principal reason for recommending HT was because the stock is selling at a discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the economic recovery. In addition, nearly a third of its major properties have been undergoing renovations and not producing their full income potential. HT saw the beginning of completed renovations and new acquisitions during the third quarter of 2014. We currently value HT's net asset value (NAV) at \$7.49 per share. However, increases in the NAV valuation will occur as income from new acquisitions are realized along with increased income from completed renovations.

**ICON Energy Fund Class S (ICENX)** has not suffered nearly as much as the drop in the price of oil. It declined 5

percent in 2014, and another 5.5 percent this year, converting our profit into a 0.9 percent loss.

In the past, this fund has achieved growth even during periods of declining energy prices, and this appears to still be the case. The changing landscape should provide opportunities ahead to capture values. For example, the stocks of oil and pipeline have also dropped along with the price of oil, even though the cost and price of storage and transportation have little to do with the price of oil. ICON management looks for changes within the energy sectors to capture value, rather than simply depending on rising oil prices.

**NCR Corp (NCR)**, formerly known as National Cash Register, makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world. A catalyst for growth comes from the fact that approximately 90 percent of ATMs in the US still run on Windows XP which Microsoft just stopped supporting. That will translate into increased demand for NCR's ATMs.

In 2013, NCR increased its debt load to make two significant purchases -- Retailix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth which caused the stock to slide to its current attractive level, at a steep discount to the market and its peers. These acquisitions pushed NCR much farther along its path from a hardware provider to more of a software and services provider where profit margins are substantially higher, and should be contributing to earnings substantially.

NCR is down 21 percent since we included it in our portfolio in August of 2014. It remains a solid value.

**Pfizer (PFE)** is up 2.3 percent this year, extending our profit to 108 percent. PFE has an arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage. Among the most significant include *Palbociclib* for advanced breast cancer, a meningitis B vaccine, and *Xeljanz* for inhibiting the progression of rheumatoid arthritis. Pfizer's top selling drugs include *Lyrica* (for pain and fibromyalgia), and *Pprevnar* vaccines (for pneumonia and other infections).

PFE's good fourth quarter's earnings capped off 2014 as a year that exceeded expectations. PFE is a good value with promising growth from a wide array of drugs and treatments along with an attractive dividend.

**Retail Opportunities Investment Corp (ROIC)** is up 4.6 percent in 2015, extending our profit to 79 percent. This REIT began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a

premium.

As new properties are added, along with tenant upgrades, FFO is bound to continue to rise, along with the dividend, and push the price of this REIT upward. Meanwhile, ROIC pays an attractive dividend that lowers its risk profile.

**Stryker (SYK)** is down by 3.3 percent this year, trimming our profit to 125 percent. SYK provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, although SYK is best known for its orthopedic devices for artificial knees and hips. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase (and obesity trends continue), more and more hip, knee, and spinal procedures will be needed.

At the end of January, SYK reported earnings of \$1.44 which was above the \$1.23 reported one year ago. In December, SYK announced a 13 percent increase in its dividend due to its cash flow and strong balance sheet. Stryker's ability to acquire attractive companies gives it multiple avenues for continued diversified growth.

**Symantec (SYMC)** is down this year by 3.3 percent, trimming our profit to 53 percent. If there ever was a more certain growth industry, protection from cyber espionage is it. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. Ninety-nine percent of Fortune 500 companies are Symantec customers. By the end of this year, SYMC will spin off its relatively small storage business as a tax-free distribution of a new publicly traded stock to SYMC shareholders. The split will allow both companies to be more competitive and responsive to their respective industries.

The spin-off will make the balance of SYMC a more attractive acquisition to large I.T. companies because SYMC is currently trading at a low valuation, has a strong balance sheet, and has good cash flows and margins.

**Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund) (the symbol is still HQL)** is up 7.3 percent this year, extending our profit to 99 percent. This Fund is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs.

This sector has outperformed the broad market during the last one, five, and ten year periods. Looking forward, the future remains bright. The population is aging and people spend more on healthcare as they get older. Although stock prices in this sector are somewhat higher than the market, they are still reasonable given the sustained out-performance we have seen in the past and the future prospects for growth. The ratio of P/E to growth (PEG ratio) of the S&P 500 Healthcare group

is slightly higher than the broad S&P 500 market but offers considerably more growth.

Healthcare and biotechnology sectors have benefitted in recent years from the approval of many new products and drugs that actually make fundamental improvements rather than merely addressing symptoms or side effects associated with horrible diseases. For example, Gilead Science's Sovaldi is revolutionizing the treatment of Hepatitis C, and is one of the best drug launches ever. Other examples that were approved in 2014 include novel drugs to treat diabetes, idiopathic pulmonary fibrosis, psoriatic arthritis, melanoma, lung cancer as well as specific forms of lymphoma and leukemia.

Also fueling growth is the Affordable Care Act which is increasing access to millions of million individuals to health insurance. In addition, we are seeing a more accommodative FDA because it has created new mechanisms for "breakthrough" products to be more expeditiously evaluated. We have also seen a significant increase in mergers and acquisitions which have lead to the approval of new products.

Also adding to growth prospects is the record number of new healthcare IPOs which has created a new generation of fledgling companies that are well funded and led by knowledgeable and experienced executives. The biotech sector is projected to exceed the earnings of nearly all other sectors of the economy. However, biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

**Tetra Tech (TTEK)** is down 13.6 percent this year, trimming our profit to 51 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet with \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. TTEK also provides energy efficiency and carbon management consulting which are bound to see growth under the new proposed carbon rules announced by the EPA which are aimed at reducing carbon emissions from power plants by 30 percent by 2030.

In January TTEK added to its backlog a \$185 million environmental remediation contract to remove toxic materials at military sites. As part of its services, TTEK may develop technologies to remediate contaminants, in soils and ground water. TTEK recently announced a two-year, \$200 million share repurchase program which will enhance earnings.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)** is down 1.1 percent since we introduced it last year. This fund invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), and the ability to consistently compound NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

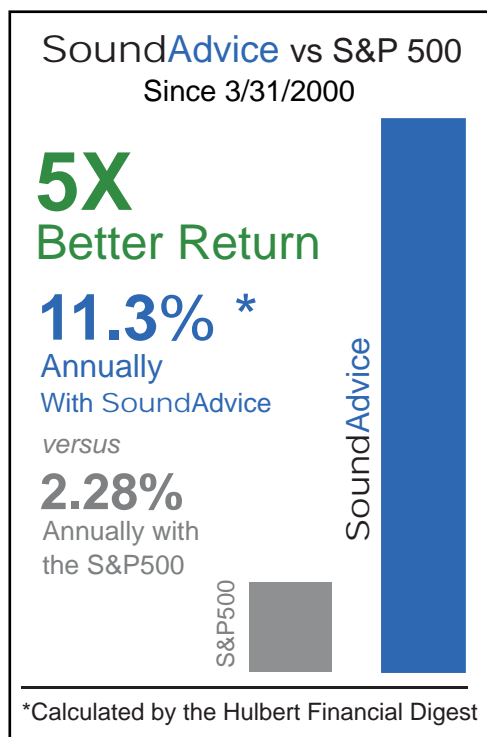
Small-cap stocks perform better than large-cap stocks over the longer term because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually profitable. Not only do small caps perform better over the long run, they generally benefit strongly from a recovering economy. In December, TVSVX paid a large long-term capital gain distribution of \$4.95 per share and a long-term capital gain distribution of 65.54 cents per share, for a total distribution of \$5.61 per share.

**Transocean (RIG)** was introduced to our portfolio because of its low valuation and high yield. Needless to say, the sharp drop in oil prices in recent months has been a jolt to RIG. In fact, the 59 percent price decline was so fast that it

was suddenly too late to sell it. We believe it is worth keeping at this point, and waiting for a brighter day.

With a stock that has become this volatile, it is difficult to know where the bottom is. The price drop has been so severe that the dividend yield is close to 19 percent. Obviously the market does not think this dividend will last, and we would have to agree.

Transocean's CEO Steven Newman recently stressed the fact that the company's current contract backlog stands at a very robust \$23.6 billion which is expected to provide RIG with \$6.2 billion in revenue in 2015, and with solid revenue visibility for several years into the future. Newman also pointed out that a majority of the company's platforms are leased by large integrated oil companies or national oil companies, and that these customers have very little likelihood of backing out of their contracts or going under. Despite Newman's optimism, the low price of the stock and the extremely high current yield indicates that the market believes the dividend will be sharply reduced or even eliminated. Based on the most recent quarter, RIG can afford to pay the dividend, and paid its dividend of 75 cents per share in December. However, for the longer-



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 24.91	3.05%	\$ 27.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 6.68	3.59%	\$ 7.86	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 17.67	3.40%	\$ 18.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 32.15	1.37%	\$ 34.00	BUY
<b>Vanguard REIT Index Fund</b>	<b>VGSIX</b>	<b>NYSE</b>	<b>\$ 28.73</b>	<b>1.24%</b>	<b>\$ 35.00</b>	<b>BUY</b>
Diversified Growth						
Agrium	AGU	NYSE	\$ 106.65	2.49%	\$ 108.00	HOLD
Ford Motor Company	F	NYSE	\$ 14.71	3.40%	\$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 16.81	7.44%	\$ 27.00	BUY
NCR Corp	NCR	NYSE	\$ 25.40	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 31.25	3.33%	\$ 35.00	BUY
Stryker Corp.	SYK	NYSE	\$ 91.05	1.16%	\$ 97.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 23.03	1.22%	\$ 28.00	BUY
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 21.88	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.17	1.90%	\$ 14.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 19.18	1.82%	\$ 26.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 30.51	1.08%	\$ 34.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 13.31	0.68%	\$ 20.00	BUY
Transocean	RIG	NYSE	\$ 16.30	15.64%	\$ 25.00	BUY
<b>USAA Precious Metals &amp; Minerals</b>	<b>USAGX</b>	<b>800-862-6909</b>	<b>\$ 13.55</b>	<b>0.15%</b>	<b>\$ ....</b>	<b>SELL</b>
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 14.81	0.00%	\$ 16.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 23.53	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 22.91	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 38.26	0.00%	\$ 65.00	BUY
Symantec	SYMC	NASDAQ	\$ 24.77	2.42%	\$ 27.00	BUY
Tekla Life Sciences Fund	HQL	NYSE	\$ 27.03	0.00%	\$ 29.00	BUY

**Notes to the table:**

Prices are as of 1/30/2015. See our website for live pricing and buy limits:

<http://www.soundadvice-newsletter.com/members>

Yields on funds may include capital gain distributions.

\* Transocean (RIG) and Agrium (AGU) yields are net of the 15 percent foreign withholding tax.

term security of the Company, the uncertainty in the oil market is likely to prompt management to prioritize its debt prepayment over at least part of the dividend.

Because uncertainty is also the most destructive force on stock prices, the announcement of a reduction would likely mark the bottom for RIG. While the near-term is uncertain, on a longer term basis, RIG is in the vicinity of a buying opportunity as the premier provider of drilling platforms to the world's major oil companies.

**USAA Precious Metals & Minerals Fund (USAGX)** has been performing poorly and the intermediate term prospects do not look particularly good, so we are selling USAGX. Gold prices generally move inversely with movements in the US dollar, and the ECB's QE program is bound to lead to further strengthening in the dollar.

**Xerox (XRX)** is down 4.6 percent this year, trimming our profit to 62 percent. We have been recommending XRX because it has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The strongest growth is coming from the expansion into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

Management's goal this year is to return \$1.3 billion to shareholders through share purchases and dividends, which is close to 10% of the company's market cap. The share buy-backs have been a significant reason for this stock's out-performance in recent years, and that trend should continue.

## 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 the SoundAdvice "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 SoundAdvice 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 SoundAdvice 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 \$12.2 million in stocks and to \$1.55 million in houses.

But though an investment beginning 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 SoundAdvice Risk Indicator he would have made \$486 million, 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 SoundAdvice 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.

### The SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.70. This reading reveals that stock prices are substantially above average in relation 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 SoundAdvice 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 SoundAdvice 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 SoundAdvice 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 SoundAdvice Diffusion Index of Leading Indicators:** As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero 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. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 33.3 percent.

**The SoundAdvice 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 which reveals that the economy is about to put upward pressures on interest rates, and to move to a cautious approach.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of the Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100 percent for the fourth month in a row in June 2014 which tells us that the economy has become strong enough to push up inflation and long-term interest rates along with bond yields. It registered 33.3 percent in December.

### Track Record of the SoundAdvice 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 climbed an average of 34.4 percent. During "Caution" signals, the S&P 500 increased an average of 2.4 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Ave +/-	34.4%		2.4%

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 paid subscription, and you will also receive an updated copy when you renew your subscription.)

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