

Taylor's Rule



New subscribers often ask how to approach investing in the portfolio recommendations.

If you are investing in the entire portfolio, we recommend spreading allocations evenly. When we recommend adding to your position, then add the same dollar amount you first invested.

If you are picking and choosing, we advise focusing on the sector of the portfolio that matches your investment objectives; income with growth, diversified growth, energy/natural resources, or aggressive growth.

Alternatively, you may have a degree of comfort with certain industries or stocks due to past experience or your profession.

Our statistics are based on an even amount invested in each recommendation. If and when the stock or mutual fund is recommended again, we assume the same dollar amount is invested again.

-Gray Emerson Cardiff

Back in the 1990s, Stanford economist John Taylor invented a mathematical formula to give the Federal Reserve an automatic guide for setting short-term interest rates as economic conditions change, in order to achieve its short-term goal for stabilizing the economy as well as its long-run goal for governing inflation.

Taylor's Rule is important to understand because Janet Yellen, in her first speech after becoming the Chair of the Federal Reserve, made it clear that she is focused on moving Federal Reserve policy back to the "Taylor Rule".

The San Francisco Federal Reserve defines Taylor's Rule as follows:

The rule states that the "real" short-term interest rate (that is, the interest rate adjusted for inflation) should be determined according to three factors:

- (1) where actual inflation is relative to the Federal Reserve's targeted level,
- (2) how far economic activity is above or below its "full employment" level, and
- (3) what level of short-term interest rates would be consistent with full employment.

The rule "recommends" a relatively high interest rate (that is, a "tight" monetary policy) when inflation is above its target or when the economy is above its full employment level, and a relatively low interest rate ("easy" monetary policy) in the opposite situations.

Sometimes these goals are in conflict: for example, inflation may be above its target when the economy is below full employment. In such situations, the rule provides guidance to policy makers on how to balance these competing considerations in setting an appropriate level for the interest rate.

Last week, John Taylor said that based on his rule, short-term interest rates (the Federal Funds rate) should be at 1.25 percent today (as opposed to the current rate of zero).

His comment was in full view of the recently announced revision regarding the 1.0 percent weather-related contraction in first quarter's GDP. However, it was before last Friday's announcement that inflation crept up to 1.6 percent in May from 1.1 percent in April.

The Federal Reserve Board has been clear about its tolerable inflation rate of 2.0 percent. As we approach that inflation rate, along with continued improvement in other economic indicators, we can be sure that today's interest rates and bond yields will not last.

Last month, we announced that our Diffusion Index of Lagging Economic Indicators (page 11) hit 100 percent based on data from March, which tells us that the economy is now strong enough to push up interest rates. That reading was confirmed again in May based on the data from April. Rising interest rates will ultimately be bad news for stocks. However, for now, it means that the economic recovery is finally getting traction which will translate into better earnings.

The “No-Brainers”

Since the first of the year, the sluggish economy has pulled down long-term bond yields, along with our ETFs that are designed to benefit from rising long-term Treasury bond yields. We have dubbed these ETFs as “No-Brainers” because interest rates always rise after a recession during the recovery. However, the upward path has never been smooth, and this time is proving 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.

To be sure, the Federal Reserve’s Quantitative Easing (QE) program has been distorting the bond market. However, the Federal Reserve is in the process of tapering these purchases by \$10 billion per month. This will drastically alter the demand side of the equation. It is important to put the QE program into perspective.

Purchasing \$85 billion of Treasury securities each month for several years has made the US Treasury the single largest purchaser. At the beginning of the year, before the Federal Reserve starting tapering its monthly purchases, it held \$2.2 trillion in Treasury securities. In second place is China whose holdings total \$1.27 trillion. Running in close third place is Japan which owns \$1.2 trillion. In a distant fourth place is Belgium with \$318 billion (\$0.318 trillion), and the rest of the world’s countries follow with smaller holdings.

QE purchases will be completely tapered by September. That means \$1.02 trillion of annual buying will be gone, which is equivalent to 80 percent of China’s entire inventory of US Treasuries.

Also noteworthy is the fact that China has not been increasing purchases recently. To the contrary, it is trying to reduce its dependence of US Treasuries and has become a net seller. Since November, China has reduced its inventory by \$44.6 billion.

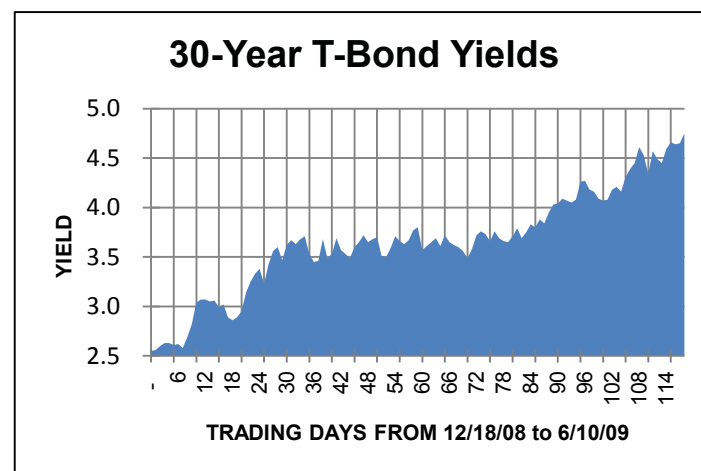
The ending of QE, removing one-trillion dollars in annual demand for US treasuries, will have an impact. It is larger than the \$0.734 trillion held by US pensions, including private pension funds, government state and local funds, as well as federal government retirement funds. Demand from rebalancing pension funds was cited in the first quarter as a source of demand and a reason for the decline in bond yields. However, any change in demand from pensions is not lasting and is relatively small.

As mentioned earlier, a few days ago, John Taylor said that interest rates should be 1.25 percent higher now. Adding 1.25 percentage points to today’s 30-year Treasury bond

yield of 3.38 percent raises it to 4.63 percent, even assuming the yield curve remains as flat as it is today. Normally the yield curve steepens with rising interest rates because rising inflationary expectations push up long term interest rates faster than short-term interest rates.

The calculation from Taylor’s Rule also squares with the historical pattern that long-term Treasury bond investors normally require a real rate of return of 3 percentage points above the rate of inflation. Adding 3 percentage points to the most recent 1.6 percent inflation rate, puts the 30-year Treasury bond yield at 4.60 percent.

The most recent time long-term Treasury bond yields rose significantly was from December 18, 2008 to June 10, 2009, (118 trading days) when we had a mild and short-lived recovery. Yields on 30-year Treasury bonds rose from 2.55 percent to 4.75 percent, or 220 basis points. The chart below shows the pattern.



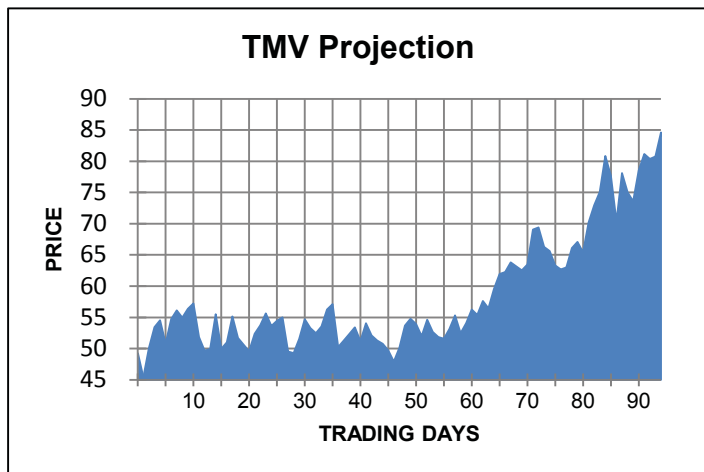
Our No-Brainer ETFs did not exist during this entire period, so we don’t have historical track records to view. However, we know how these ETFs work, and can model them to get an idea of the profit potential.

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 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.

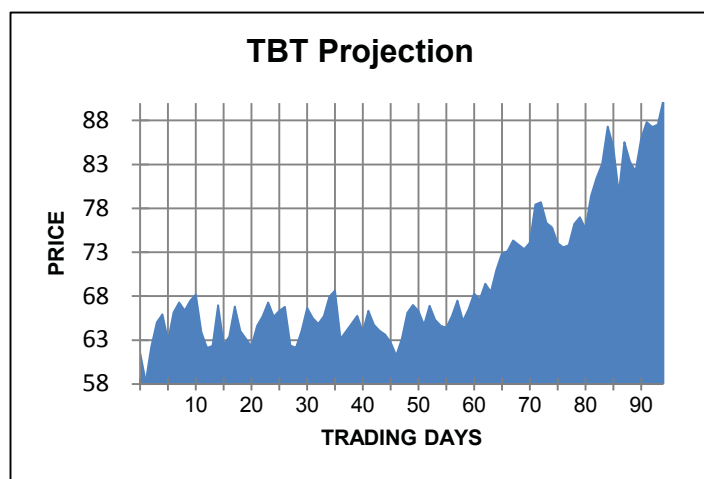
To construct our models, we start with a projection of an increase in 30-year Treasury bond yields. A conservative approach would be to assume that long-term Treasury bond yields will not rise beyond 4.75 percent -- not any higher than the last peak. We can use the pattern of the last 91 days of the 220 basis point rise when yields rose from today’s yield of 3.38 percent to the peak of 4.75 percent. In that scenario,

our No-Brainers would rise to the following levels:

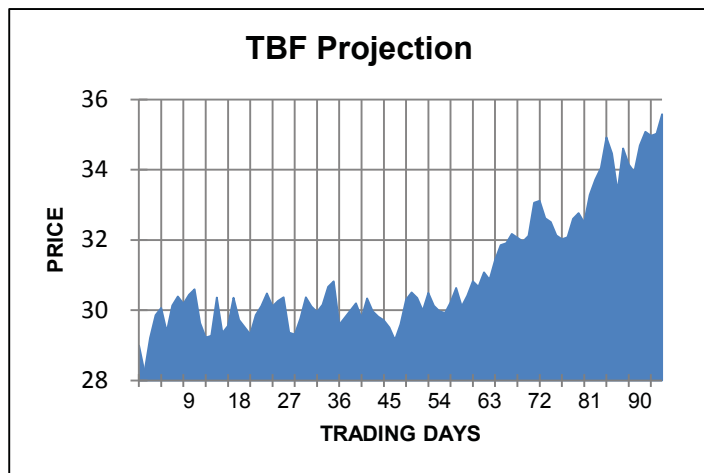
TMV would climb to \$84.6, for a 71 percent gain. The following chart shows the pattern.



TBT would climb to \$90, for a 47 percent gain. The following chart shows the pattern.



TBF would climb to \$35.5, for a 22.6 percent gain. The following chart shows the pattern.



While the pattern of today's rise is unlikely to be exactly the same as the previous rise, a 4.75 percent yield serves as a reasonable target. After yields rose to 4.75 percent on

the last rise, the economy was considerably weaker than it is today and subsequently went into a decline.

It is important to note that a target of 4.75 percent does not require a full recovery to the inflationary stage of the business cycle. Our objective is only for Treasury bond yields to recover to normal levels, to the vicinity of 4.75 percent, from the artificially low yields caused by the 2008-09 economic meltdown and the subsequent massive bond purchases under the Federal Reserve's unprecedented QE programs.

Portfolio Updates

Here are updates on the rest of our recommendations in alphabetical order. The table on page 9 details our buy limits and other information on each recommendation, and organizes them by investment objective. Also see our website for live pricing.

Agrium (AGU) is essentially unchanged this year, leaving our profit to 680 percent. AGU has a broad mix of agricultural products and services that are poised to benefit from growing demand as arable land continues to disappear around the world and the need for higher food production per acre increases. Growth is also bolstered by an expanding worldwide population along with increasing per-capita income.

AGU reported low earnings of \$0.07 per share for the first quarter which was slightly better than expected. In April, management announced that AGU's first quarter earnings were going to be flat as a result of Spring's late start and the delay on railroad deliveries. Earnings for 2014 are projected to be in the vicinity of \$7.00 and then increase to approximately \$9.00 in 2015.

In late May, AGU announced the sale of its turf and ornamental business to Koch Agronomic Services, an affiliate of Koch Fertilizer LLC, for \$85 million. CEO Chuck Magro said that he was pleased with the value received, and will continue to focus on optimizing our portfolio and product lines to generate additional value for our shareholders.

AGU has a solid 3%+ dividend yield and is undervalued at 10 times the expected 2015 earnings of approximately \$9.00.

AMN Healthcare (AHS) is down 24 percent this year, trimming our profit to 110 percent. AMN Healthcare provides temporary healthcare staffing services to the healthcare industry, ranging from nurses to physicians. We recommended this stock at an average price of \$5.35 based on the rationale that it was a two-fer. AHS was not just an opportunity to invest in healthcare, which is traditionally a non-cyclical industry, but it was also a chance to buy into a healthcare business that would benefit from a recovery in the economy.

As our growth forecast was panning out, the stock advanced sharply in 2013. As its price/earnings (P/E) ratio expanded above 20, we recommended holding off on purchases. Since then, the stock price has been slipping.

AHS dropped below \$11 on May 5, into our buy range, when disappointing earnings were reported of \$0.16 per share. Factors impacting the first quarter were lower census volumes, a lighter flu season, and adverse weather. The Affordable Care Act is still expected to drive greater demand for clinicians over the longer term, but the immediate impact has been lower utilization of healthcare services due to the difficulty in predicting workforce needs.

As the newly insured begin to utilize healthcare services, temporary staffing volumes are expected to increase again. Meanwhile, AHS is focused on expanding its most profitable managed service programs (MSP) whereby the staffing needs of clients are systematically matched. MSP contracts accounted for 34 percent of first quarter 2014 revenue versus 30 percent from the previous first quarter.

Growth should be aided by recent acquisitions. Shiftwise was purchased in November for its hospital vendor management system. In May, AHS announced a commitment to invest \$5 million in PipelineRx which delivers cognitive medication management services focused on clinical telepharmacy to acute care hospitals. AHS is continuing to focus streamlining its systems and infrastructure to create greater efficiency, scalability, and agility.

We continue to recommend keeping purchases below \$12.

Associated Estates Realty Corp (AEC) is up 11 percent so far this year, extending our gain to 25 percent. What originally attracted us to AEC was the fact that it was selling at a substantial discount to the value of its net assets, and it paid a nice dividend. Although AEC has since risen in price, so has the value of its real estate portfolio. It remains a stellar value with a nice dividend of close to 4.5 percent.

When considering investing in a REIT, the first question to ask is “What am I paying for the real estate?” In other words, what is the stock market paying for the real estate based on the current price of the REIT?

We can determine what the stock market is paying for the underlying real estate by starting with the market capitalization of the REIT (the market price of the stock times the number of outstanding shares) and then backing out the non-real estate assets and liabilities, including any debt. What remains is the price that the stock market is currently paying for the real estate.

We can then evaluate this price by dividing that price into the net operating income (NOI) the real estate produces. Like a bond, the value of real estate is based on its yield. In real estate parlance, this yield is called the “capitalization rate”, or cap rate.

We have recently performed this exercise on the 10 largest apartment REITs based on their latest 2014 first quarter financial reports. We determined that the stock market is essentially paying a 5.32 percent cap rate for the apartment properties in these 10 REITs, based on their current stock prices.

If we value AEC's apartment portfolio at a 5.32 percent cap rate, it translates into a stock price for AEC of \$28.45. That is 40 percent greater than the current stock price.

As a confirmation of our calculations, we see that AEC sold three of its apartment properties during the 2014 first quarter for an average cap rate of 5.4 percent. Evidently, both Main Street and Wall Street believe the current market value for apartment properties is close to the same.

Several years ago, there was a reason AEC would sell at a discount to its peers. It was primarily a low-income housing REIT in Ohio. However, AEC has since disposed of those properties and diversified into 54 high-quality apartment communities with 13,964 apartment units in ten states. Along with its recent diversification into California, AEC made significant moves to reduce its debt. Occupancy ended the first quarter at 96 percent, along with continued improvements in net operating income. AEC has become a more typical apartment REIT with properties comparable to its peers. However, it still trades at a substantial discount to the value of its underlying real estate.

Boston Scientific (BSX) is up 7 percent so far this year, extending our profit to 36 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.

Although BSX has many divisions, it is best known for its cardiovascular stents produced by its largest division, Interventional Cardiology. First quarter earnings were bolstered by increased sales from this division. In May, there was positive 3-year data reported from BSX's SYNERGY Stent System with regard to both safety and efficacy. This stent system is a new innovation and not yet available for use in the US and Japan, but the approval process in both countries began in August 2013, and May's positive 3-year results will be supportive.

Chesapeake Energy (CHK) is up 8 percent this year, extending our gain to 78 percent. CHK is the second largest

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producer of natural gas and pioneered the use of fracking technology to produce oil liquids and natural gas from shale. We 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.

While company founder Aubrey McClendon was instrumental in “wildcatting” the company’s considerable oil and gas assets, the operations of the company have become rational under its new chief Douglas Lawler who came over from Anadarko. Spending levels are within budget, head counts are reduced, and capital allocations have become more properly allocated.

In early May, CHK announced first quarter earnings of \$0.59 per share versus \$0.30 in the same quarter last year. Production increased 11 percent over the same period.

The Company raised its 2014 total production growth outlook by 9 to 12 percent based on higher natural gas liquids volumes. In addition, 2014 operating cash flow outlook was increased 13 percent because of increased overall production.

During the 2014 first quarter, CHK realized an average natural gas price of \$3.27 per thousand cubic feet (mcf), a large increase from \$1.90 per mcf in the 2013 fourth quarter because of higher prices in general, unusually cold weather, and increased access to premium priced markets in the Northeast.

CHK’s operating results are strengthening due to increases in production and cost reductions from its most significant assets, including Eagle Ford Shale in South Texas, its mid-continent assets, and its Utica and Marcellus Shale operations in Ohio, Pennsylvania, and West Virginia.

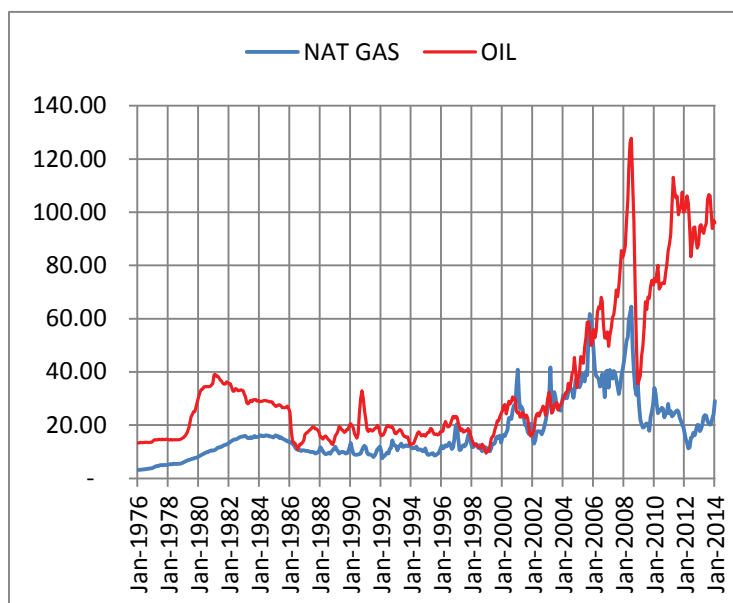
Value Line’s fair value estimate of CHK is \$38 which is well above the current stock price.

CommonWealth REIT (CWH) is up 16 percent this year, extending our gain to 167 percent. We originally introduced CWH when it was selling for close to a 50 percent discount to its NAV. Subsequently, two large investors, Corvex and the Related Companies, woke up shareholders and sponsored a proxy vote to remove the entire board and management.

After receiving an astonishing 81 percent vote from shareholders to oust the board and management, the election of a new board occurred on Friday, May 23, and 85 percent of shareholders voted in favor of the proposed board. Newly elected chairman billionaire Sam Zell said, “With our team in place, we can get to work executing on our goal to create long-term value for our shareholders.”

Based on the latest financials, we currently value CWH stock at approximately \$32.50 per share, which is still substantially above the current stock price. As a confirmation of our valuation, Corvex/Related has contended the stock is worth more than \$40 per share with better management.

The Cost of Energy Equivalents of Oil and Natural Gas



Fidelity Select Natural Gas Fund (FSNGX) is up 17 percent this year, extending our gain to 39 percent. This fund concentrates on the natural gas industry, and it is a diversified play on the gap between the energy equivalents of oil and natural gas.

The US is self-sufficient in natural gas with only 9 percent imported from Canada. At pennies on the dollar versus oil, natural gas is bound to have a growing role in America’s energy needs as well as creating independence from imported oil. This fund is well positioned to benefit from an expanding natural gas industry.

Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other sources of energy, which translates into an inexorably vibrant and expanding natural gas industry.

One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. With one barrel of oil at \$95, that is the cost of 5.8 million BTUs of energy. On the other hand, with a market price for natural gas at \$5.00 for one million BTUs, 5.8 million BTUs will cost \$29 (5.8x5). So the same amount of energy is available for 30 cents on the dollar -- if it is in the form of natural gas.

To illustrate the point, we continue to display the historic relationship between the costs of these two forms of energy in the chart above because it demonstrates that today’s disparity is not a normal situation.

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. Note that for most of the time (36 years), the two forms of energy are closely aligned. This stands to reason. After all, energy is energy, and it should cost approximately the same regardless of the form in which

it comes. However, that is not the case today.

Freeport-McMoRan Copper & Gold (FCX) was originally added to the portfolio in late August at \$30.42 per share. FCX is up 30 percent since we recommended it.

Copper is woven into the fabric of every developed economy, 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. In March 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. As the world's economies continued to expand into 2008, so did FCX.

Since the Phelps Dodge transaction, FCX has added substantially to its copper reserves and continues to have opportunities to add reserves because of its large resource base and ongoing exploration program.

Another feature that attracted us to FCX was its 2013 acquisition of substantial oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. Diversification into these oil and gas assets was a departure for FCX which was previously known purely as a copper producer. This diversification was another reason for recommending FCX because the upside and stability from this sector was a definite attribute that was not built into the price of the stock (and it still isn't).

In May, FCX announced that it is acquiring Apache Corporation's interests in a deep-water platform in the Gulf of Mexico, called Lucius, a world class reservoir in which FCX already had a 23.3 percent interest. The operator is still Anadarko which holds a 27.8 percent interest. The purchase will be funded with proceeds from the recent sale of its Eagle Ford shale assets for \$3.1 billion. The net after-tax proceeds of \$1.3 billion will be used to repay outstanding debt. The initial production from Lucius is expected in the second half of this year which should add significantly to revenues and earnings. Other natural gas assets in the Gulf of Mexico and Gulf Coast region are also promising because the initial wells indicate substantial, long-producing geological formations.

FCX is modestly priced in view of the current earnings and the growth that is around the corner. Meanwhile the dividend yield is attractive and reduces risk.

Hambrecht & Quist Life Sciences Fund (HQL) is up 3 percent this year, extending our profit to 127 percent.

We have been recommending this Fund because the most explosive profits in the entire healthcare industry can be found in biotech companies, and this fund is an excellent way to participate in a promising future on a diversified basis. There are bound to be home runs among its holdings, and all of the Fund's holdings that have promising drugs and treatments.

In May, HQL announced the terms of a rights offering which entitles shareholders to purchase one additional share for every 3 shares held on May 30, 2014, for a 5 percent discount of the June 25 closing price. HQL shares currently

sell for a 3.5 percent discount to NAV which would mean an 8.5 percent discount if it were priced today. The proceeds from the Offering (if commenced) would allow the Fund to take advantage of new investment opportunities without having to reduce existing holdings.

We recommend taking advantage of the offering.

Hersha Hospitality (HT) is up 13 percent since our recommendation in December 2013. Our principle reasons for recommending HT was because hotel assets in general are sensitive to the business cycle and will benefit strongly from the economic recovery.

In addition, the price of the stock is depressed and selling at a discount to its net asset value because many of its major properties have been undergoing renovations, and the income potential has not yet been realized.

In May, HT announced first quarter funds from operations (FFO) of \$11.6 million, an increase of \$3.5 million (43 percent) despite the unusually cold weather.

Based on the most recent first quarter financials, we value HT's NAV at \$7.33 per share, which is substantially higher than the current price of the stock. We expect to see further increases of NAV in the immediate quarters ahead as income from new acquisitions are realized along with increased income from completed renovations.

During the first quarter, HT completed the sale of 16 properties that were performing below the average of the rest of the portfolio.

In April, HT closed the sale of Hotel 373 in midtown Manhattan for \$37.0 million, (approximately \$529,000 per key), and part of the sale proceeds were used to repurchase 2.6 million common shares. This sale was at an effective cap rate of 5.2 percent. We are using a more conservative cap rate of 7.0 percent to evaluate the whole HT portfolio.

In May, HT announced that it contracted to purchase the 148-room Parrot Key Hotel & Resort in Key West, Florida, on 5 oceanfront acres, the most recently built waterfront hotel with the largest rooms and the most oceanfront suites in Key West. The purchase price was \$100 million which is a cap rate of 7.2 percent based on the last 12 months (trailing) net operating income. Based on the projected income in the year ahead, the cap rate is 7.5 percent. HT expects the purchase price to yield a cap rate of 9.0 percent when the full potential of the property is stabilized.

These last two transactions are evidence that management knows how to buy low and sell high.

HT has an excellent risk/reward ratio. Risk is minimized with the stock below a currently depressed net asset value. The dividend is solid because it is well-covered by funds from operations (FFO). A yield close to 3.8 percent is attractive and limits downside movement in the stock price.

ICON Energy Fund Class S (ICENX) is up 9 percent since we added it to the portfolio last year. Demand for energy accelerates with an economic expansion, and we expect to see solid gains as the economic recovery gains traction.

It takes energy to make everything, and especially large amounts to make the most vital materials and substances, such as chemicals, plastics, and to run data centers. The best time to invest is when the economy is coming out of a slump, before demand increases.

Aside from the cyclical timing, above average investment returns can be earned over the long run. Over the last 10 years, the Energy Equity Index has produced superior investment returns to that of the S&P 500. That performance is because energy is in the fabric of the economy.

Most energy mutual funds have not been able to match the performance of the Energy Equity Index. However, this fund not only beat the Energy Equity Index resoundingly, it has turned in the best performance – by far – of all energy funds.

ICON management looks for changes within the energy industry to capture value, rather than simply depending on rising prices. Management points out that it has achieved growth even during periods of declining energy prices. The track record of this fund bears this out. For example, from March 31, 2011, through March 31, 2014, both oil and natural gas prices declined while the fund produced positive growth.

Pfizer (PFE) is down 2 percent this year, trimming our profit to 83 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on its blockbuster drug, *Lipitor*. However, its future was brighter due to the arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage.

In late April, PFE announced its attempt to buy its British rival AstraZeneca (AZN) for \$100 billion, the largest price tag since PFE purchased Warner Lambert for \$85 billion. After raising the offer close to \$120 billion, AZN gave its final refusal on the basis that the company was worth more. U.K. takeover laws prohibit Pfizer from making another unsolicited offer for the next six months, but the deal could be revived in three months if AstraZeneca invites talks.

While AZN's large portfolio of cancer drugs would be synergistic with PFE's roster, the primary motive for PFE was for tax advantages. A merger would allow PFE to put some of its \$69 billion overseas cash to work which would otherwise incur a repatriation tax if brought into the US. The merger is another so-called "inversion" whereby PFE acquires AZN and then incorporates the combined company in the UK while keeping the Headquarters in NY. PFE paid taxes at the rate of 27.6 percent in 2013 while the top UK tax rate for corporations is currently 21 percent, declining to 20 percent next year. Tax savings were projected to be in the hundreds of millions. In addition, PFE would benefit from the UK's more favorable tax treatment on income from patents and other intellectual properties.

PFE is down slightly since the AZN negotiations were called off, and below our upper buy limit.

Retail Opportunities Investment Corp (ROIC) is up 9 percent this year, extending our profit to 54 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. During 2013, ROIC acquired ten grocery-anchored shopping centers for \$368 million. Funds from operations (FFO) increased during the year as these properties were added.

Results continued on a positive path during the first quarter, marking the ninth consecutive quarter of increasing same-center income.

During the first quarter, ROIC generated property operating income of \$26.5 million, an increase of \$8.8 million (50 percent) over the same quarter one year ago. The increase is mostly due to the greater number of properties owned (57 versus 46). FFO has climbed 10.5 percent during the last four quarters from increases in rental income and from the addition of new centers.

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 a 4+ percent dividend that is bound to increase in the years ahead.

Stryker (SYK) is up 13 percent this year, extending our profit to 106 percent.

SYK is best known for its orthopedic devices for artificial knees and hips. SYK also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. 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.

Stryker's cash-rich balance sheet with \$4 billion of cash and marketable securities, along with robust cash flow, gives SYK multiple avenues for continued growth through acquisitions.

Recent acquisitions include Pivot Medical which provides SYK with a platform of arthroscopic implants to efficiently access the hip with minimal incision. SYK also recently acquired Berchtold Holding, which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems.

The MAKO Surgical acquisition put SYK in a leading position for robotic-assisted surgery and the potential for break-through innovations.

The 2013 purchase of Trauson Products, China's largest manufacturer of orthopedic implants, also offers an important source of growth. With 194 million Chinese over the age of 60, this demographic bulge is gaining wealth. Trauson gives SYK access to the Chinese market and broadens SYK's customer base. Trauson's devices are purchased by 3,000 Chinese hospitals, generally lower-income hospitals that cannot afford Stryker's more expensive products. With the diversity of products, SYK can serve both China's developing

and developed areas.

Symantec (SYMC) is down 7 percent this year, trimming our profit to 34 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. If there ever was a more certain growth industry, protection from cyber espionage is it.

We have been recommending SYMC because it is undervalued. Recent “sum-of-the-parts” valuations range from \$25 to \$28 per share, a premium over the current price of the stock.

At the end of May, SYMC announced an innovation in mobile device management by integrating threat-protection for both browser applications and email into one utility. Symantec is the first company to integrate mobile device management with capabilities unmatched by any other mobile device management solution by combining tools in a single console that provides protection from viruses, malware, freeware, fraudulent websites, and privacy risks. Behind the integrated utility are proprietary intelligence tools that process 10,000 new apps every 24 hours to determine potential security risks.

In May, SYMC acquired one of its previous long-term partners, NitroDesk, a popular mobile email application with the mission of securing email and corporate data on mobile devices. SYMC believes this will be a significant step in the advancement of mobile threat protection.

Adding to growth for SYMC is the grim fate of Blackberry. The majority of enterprises relying on Blackberry are looking for alternative mobile business email options.

Tetra Tech (TTEK) is down 7 percent this year, trimming our profit to 70 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet and a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. There is plenty to clean up domestically, and the greatest growth potential continues to be outside the United States, especially in China and India, where environmental concerns have been an afterthought. As these and other governments around the world make this a priority, Tetra Tech should be a prime beneficiary.

TTEK has a strong balance sheet with \$500 million of capital for growth in strategic markets. Late in 2013, the board of directors authorized a \$100 million common stock repurchase program. In April, 2014, TTEK initiated its first quarterly dividend of 7 cents per share.

TTEK is initiating several tactics to improve the business and improve cash flow as well as make earnings more consistent. One was the reorganization and streamlining

of the Offshore Services Division which provides deep-sea services.

Another initiative is expanding its US Compressco business by adding equipment for low pressure natural gas wells which represent over half of all wells with less than 10 percent of the production.

To benefit from the growth in fracking, TTEK is introducing a “Lay-Flat” hose, similar to a fire hose, that is easier to handle and less costly than metal hoses.

TTEK has also reduced its general and administrative costs by \$13 billion through consolidating functions and management.

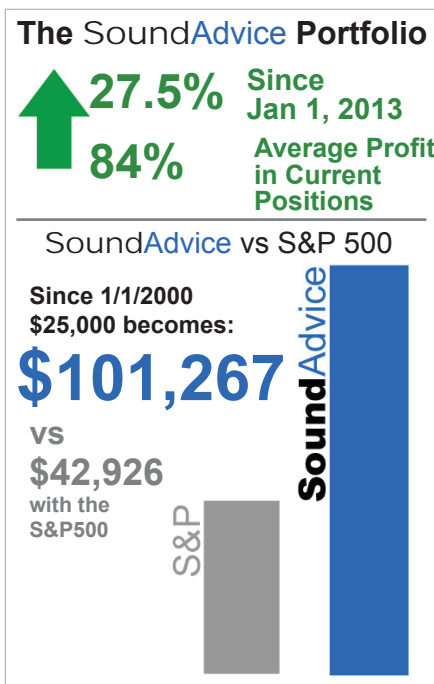
Third Avenue Funds are in our portfolio because the management team looks for 4 fundamental characteristics before making investments:

- 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).

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 18.6 percent. It has led the pack of all real estate mutual funds during the last 3 years. This is still where the best real estate values can be found in a mutual fund. It is replete with stellar values substantially below NAV with strong growth prospects.

Two months ago, we introduced the **Third Avenue Small-Cap Value Investor Fund (TVSVX)** which invests in companies with small capitalizations using the same value-oriented approach. 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.

USAA Precious Metals & Minerals Fund (USAGX) is up 11 percent this year. When the economic recovery gets more traction, the money created in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities including precious metals. This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is the top-performing fund, and has constantly out-



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 17.41	4.37%	\$ 18.50	BUY
CommonWealth REIT	CWH	NYSE	\$ 26.87	3.72%	\$ 27.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 6.35	3.78%	\$ 6.50	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 15.92	3.77%	\$ 17.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.34	2.11%	\$ 33.00	BUY
Diversified Growth						
Pfizer	PFE	NYSE	\$ 29.71	3.50%	\$ 32.00	BUY
Stryker Corp.	SYK	NYSE	\$ 84.83	1.25%	\$ 84.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 27.46	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 12.41	2.01%	\$ 12.50	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE	\$ 90.07	3.33%	\$ 100.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 29.31	1.19%	\$ 30.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 43.48	0.76%	\$ 45.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 34.12	3.66%	\$ 37.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 23.79	3.11%	\$ 25.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 26.14	0.00%	\$ 27.50	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 14.12	0.14%	\$ 18.00	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$ 11.18	0.00%	\$ 12.00	BUY
Boston Scientific	BSX	NYSE	\$ 12.88	0.00%	\$ 13.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 49.34	0.00%	\$ 62.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 29.01	0.00%	\$ 32.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 61.53	0.00%	\$ 71.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 20.60	0.00%	\$ 25.00	BUY
Symantec	SYMC	NASDAQ	\$ 21.86	2.74%	\$ 22.00	BUY

Prices are as of 6/2/2014. See our website for live pricing and buy limits. Yields on funds may include capital gain distributions.

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

performed precious metal equities for ten years.

Xerox (XRX) is up 2.2 percent this year, extending our profit to 46 percent. We have been recommending XRX because it has been transforming from purely a seller of printers and copiers to a company providing services on those machines along with developing information technology (IT) services. In 2013, the strongest growth came from the expansion into IT services, especially in the healthcare industry where technology is needed to reduce costs. In 2013, business processing outsourcing (BPO) revenues represented 57 percent of the company's total revenue.

Ongoing acquisition activity should bolster earnings growth this year. The latest addition was the January purchase of Invoco, the world's largest generator of BPO revenues. This acquisition follows Xerox's similar customer care acquisitions in the European market, including both WDS (U.K.) and XL World (Italy) in 2012, and Unamic (Benelux region) in 2011. The addition of expanded BPO capabilities to Germany adds to those in the United Kingdom, France, Netherlands, Belgium, Turkey, Czech Republic, Romania, Italy and Albania.

At the end of May, XRX was awarded a five-year, \$500 million contract to develop a new Medicaid claims processing system for the state of New York.

During the last three years, XRX has repurchased \$816 million of its stock annually. Free cash flow continues to be strong. Management indicates that it will use some of its free cash flows to continue to buy back more stock in 2014 close to that average, and that beyond 2014, XRX plans to repurchase another \$1.0 billion of its stock.

XRX expects to post earnings of \$1.07 to \$1.13 per share for the year. At close to 10 times earnings, XRX is at a steep discount to the overall market and cheap in comparison to its competitors like IBM and Canon. XRX raised the next quarterly dividend by 8.7% to \$0.0625 per share (\$0.25 annually).

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

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 \$11.3 million in stocks and to \$1.4 million in houses.

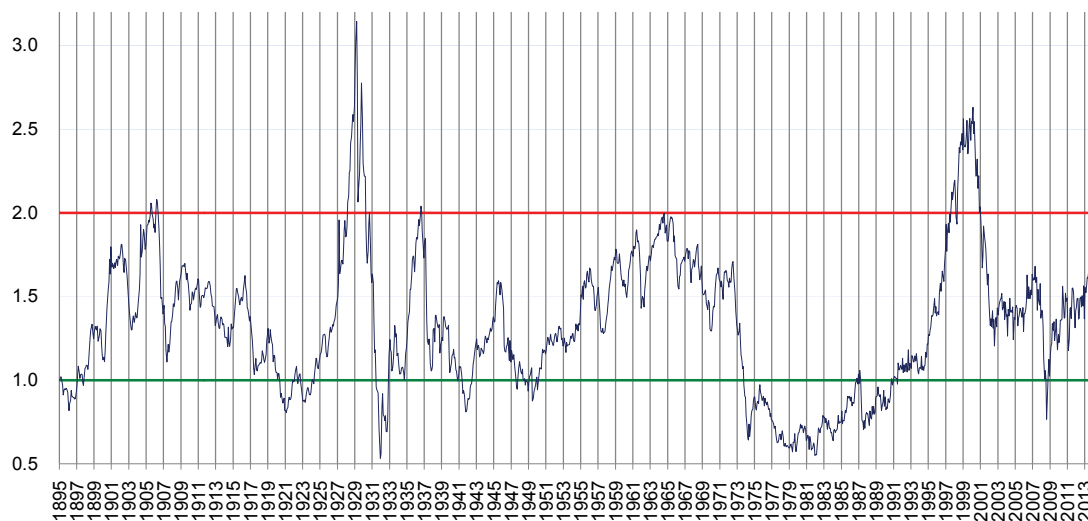
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$449 million, or 39.7 times more money—the 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 Sound Advice Risk Indicator is 1.64. This reading reveals that stock prices are 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 Sound Advice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you re-new 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 66.7 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 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% in again in April, 2014, based on the March data, and again in May based on the April data. With the Quantitative Easing program winding down, this confirms our "Caution Signal".

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 1.7 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%		1.7%

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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