

SOUND ADVICE

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What a Month



I was talking with Steve Horwitz, my managing editor, about how investors develop their styles. He is a deep-value guy, willing to buy in bad markets, which, if you're paying attention, we have now in spades.

He recalled his first serious investment, which was back in the 1980s after Texaco lost a \$10.5 billion civil judgment (and that was when a billion dollars meant something) to Pennzoil over what amounted to corporate-style alienation of affection. Steve called his broker when TX was under \$30 and bought a thousand shares. He continued to buy TX, especially after it declared defensive bankruptcy. The outcome, of course, was exquisite. Texaco worked out a deal with Pennzoil and much later Texaco was bought by Chevron. Today his investment is worth probably ten times what he paid. The dividend alone is a 25% yield on his original cost basis, and he has been reinvesting those dividends for 23 years.

I asked, did that turn you into a contrarian investor? He said that he doesn't think investors "develop" their fundamental approach to investing. They might learn new ways of understanding the market, but the most basic attitudes whether they be value or growth or index neutrality, just get revealed over time.

Though *Sound Advice* favors deep-value investing, it is possible to make money regardless of style. However, what does not work is flip-flopping from one style to another just because it's in fashion. Ultimately you have to know who you are as an investor and stick to that discipline, though, as right now, it can be trying.

—Gray Emerson Cardiff

Like the abrupt national debate over physical infrastructure that followed collapse of the I-95 West bridge in Minneapolis, the markets' sudden consuming concern over our credit infrastructure is stunningly belated. Just as civil engineers have warned for decades that government at our peril preferred to build new stuff rather than maintain existing bridges, roads, and other less visible infrastructure, financial Cassandras had warned that cheap credit and creative financing on both the ground and the institutional levels would lead not to constructive economic growth but to unsustainable debt creation. The securitized-debt debacle unfolding now in the housing market and the drying up of junk lending to support those leveraged private buyouts are just the bill for what some assumed was a free lunch.

What hit the market last week was panicky recognition that the relatively free money and the mentality that had created the "Santa Claus Market" are goners. A long piece in the *Wall Street Journal* on August 7th traced the origins of that cheap credit all the way back to how the Federal Reserve, federal regulators and legislators confronted the S&L crisis in the 1980s, the Asian crisis of 1997, and the post-bubble economy's slide into recession here in the U.S. Just fire up the electronic printing presses.

Even if no one at the Federal Reserve while it was pumping credit into the U.S. economy during these various crises knew exactly what the unintended consequences of their actions might be, the Fed Chairman did anticipate some blowback. It is ironic that during the housing bubble, which burgeoned thanks to real Fed Fund rates that hit zero, none more than the Chairman himself, Alan Greenspan, spoke more glowingly about the benefits of his last great jolt of credit: New, creative mortgage instruments that extended the blessings of home ownership to those who before never dreamed of owning their own homes. Even now, as those mortgages implode, Mr. G expresses no regrets, since he believes the impact his easy money policies had on the economy prevented a shallow recession from deepening and instead launched a boom. Easy come, easy go.

If you want some perspective on how smashingly successful cheap credit has been on the housing market, consider this: in 1994, the

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subprime market was \$35 billion. In 2006, \$665 billion. And, contrary to the dewy happy-talk from Mr. Greenspan about subprime mortgages making home ownership possible, the majority of subprime loans it turns out were not used to purchase homes but to refinance them. In other words, subprime loans allowed strapped home owners to borrow against whatever equity they had accumulated.

Despite earlier clockwork assertions from Ben Bernanke at the Fed and Henry Paulson at the Treasury that the consequences of the subprime problem would be "contained," matters have escalated beyond the mortgage lenders to banks, hedge funds and institutional investors who hold the repackaged mortgages. Many companies with only the most tangential ties to the subprime mess are suffering nonetheless, and an anxious market frets that any stock that falls must be another subprime victim regardless of whether any connection at all can be divined.

The Fed and Treasury are now acting as if contagion, not containment is the case. Intervention by both the Federal Reserve and to a much larger degree by foreign central banks to inject credit into the market sounds mechanical, almost antiseptic, but in reality it is central bankers conceding that they are now the buyers of last resort for the most highly rated subprime derivative debt that no one else is willing to touch. Perhaps the "containment" Bernanke and Paulson had in mind was containment of that debt on the Fed's books.

WHAT IT MEANS FOR US

The \$64 (add zeroes at your pleasure) question is whether the market dive will stop here, be contained to a garden variety 10% reversal (since hitting its high on July 19, the S&P tumbled 6.6%, the small-cap Russell 2000 dove 12.6%), something that is part of the regular ebb and flow of a rising market but also something investors have not experienced in four years, or something more painful. The current damage fits neatly alongside similar drops in March 2004 (6%), March

2005 (6.5%) and this February (5.1%). The damage so far seems to be a reflexive response to crises among large institutional investors with exposure to the collapse in securitized-mortgage debt and the simultaneous paralysis in being able to float junk debt to finance leveraged buyouts. It does not seem the prelude to devastation.

Annihilation of several multi-billion dollar hedge funds here and abroad whose strategies were built on owning highly leveraged securitized mortgages is par for such unraveling. For stocks, however, the damage is less expected but no less real. Credit market chaos has forced hedge funds and institutional investors with balanced portfolios, even those with minimal or even no exposure to toxic subprime paper, to sell stocks they had bought with borrowed money not only because renting that money is suddenly more expensive but also because it's more risky. Goldman Sachs noted that those stocks most widely held by hedge funds had lost 6.28% more than the overall market since prices topped out on July 19th. Furthermore, mutual funds are also selling both for strategic reasons and to meet rising redemptions as small and large investors scurry out of falling equities. What gets sold at such times is where profits had accumulated: energy and metals for instance.

Our advice is to nibble at good values, not run for the exit. For instance, **American International Group**, because it has some exposure to mortgages, is suspect. But that exposure seems modest, particularly compared to the rest of its book. It has been dinged nonetheless. Those are the signs of a good deal. Remember Shelby Davis' maxim that we make our best profits during bear markets though we don't know it at the time.

We're not promising that equity prices are primed immediately to surge higher, just that for patient investors if what was worth owning last month when we were on top of the world is cheaper today, that is reason enough to accumulate those assets. Not a comfortable strategy, I know, but over time it has been very, very profitable. **SA**

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Eat Right. Make Money

The Wall Street wheel of fortune eventually dumps into the value bin stocks we once shunned because their high-altitude price ratios had left no room for error, and we buy them. **AIG, Wal-Mart, SBC (now AT&T), McDonalds, Johnson & Johnson, Gillette, Microsoft**, all were too pricey before they got cheap. Now we have **Whole Foods Market (WFMI—Nasdaq)**, which we thought too rich for our budget when recommending **Safeway** in 2003. Indeed, in 2006, just as Safeway started to reap revenue and profits after learning how to distinguish itself from other mainstream grocers and ultra-cheap Wal-Mart (it just needed to upscale itself by taking pages from competitors like Whole Foods' playbook), and its shares took off, Whole Foods went into decline.

That decline in part simply was the market reconsidering what had been overheated enthusiasm about the Whole Foods concept and prospects. If Safeway could mimic some of Whole Foods' magic, maybe investors needed to reprice the upstart natural foods marketer's prospects. Encouraging that reduced passion were the last few quarters when compared to analysts' expectations. After the Federal Trade Commission sought to block WFMI's bid to buy its biggest competitor, Wild Oats, which was followed by Whole Foods' charismatic founder and CEO, John Mackey getting in trouble for anonymously posting on Internet stock bulletin boards remarks that boosted his company's prospects and blasted his competitors', the shares fell as low as \$36 just three weeks ago. A perfect storm, we thought, a great time to recommend a beleaguered blue-chip. But with the first suggestion that perhaps Whole Foods was recovering, the shares started to move higher despite a declining market.

We think that the FTC is being as foolish as Mackey was in his ill-considered comments and that the merger will occur. We also believe that Whole Foods, regardless of other grocers' ability to capture some of its magic, is in a class by itself and at current valuations remains on sale. It also yields 1.7%

WHOLE FOODS

Mackey and his girlfriend started what would become Whole Foods 29 years ago in Austin, Texas, with the implicit—if at that time laughable—intention of taking

on the grocery industry. With shelves stocked exclusively for vegetarians in search of pure foods, that first store opened under the name "Safer Way," an unsubtle jab at mainstream grocers. However, Mackey quickly recognized that not only did he need to cater to more than Austin's vegetarians but he also needed to carry some products that might not meet organic purists' most exacting standards. No, they did not start selling Twinkies and cigarettes, but they did include some conventional (= non-organic) fruits and vegetables, and canned and frozen products. Most importantly, Whole Foods introduced prepared foods.

The major growth engine that turned WFMI into a national presence was the acquisition of regional natural food grocers, most of which were less chains than small clusters: North Carolina (2 stores in 1991), Massachusetts (5 stores in 1992), Southern California (7 stores in 1993), Atlantic coast and Chicago (22 stores in 1993), Florida (2 stores in 1997), metropolitan Detroit (6 stores in 1997), Massachusetts (4 stores in 1999), Northern California (3 stores in 2000), Atlanta (3 stores in 2001), United Kingdom (7 stores in 2004). Along the way, Whole Foods acquired wholesalers and processors for coffee, fish and other products as well as distribution and preparation kitchens. Whole Foods has acquired not just retail outlets through these acquisitions but expertise from their founders and managers, which it happily incorporates into how the entire chain operates.

As 2006 dawned, management planned to grow through an ambitious building plan. Whole Foods had 6.4 million square feet of retail space, an increase of 10% over the previous year, and by 2010 intended to have another six million square feet in new and expanded stores that management expects will more than double sales.

Then news broke that Whole Foods would buy its largest competitor. Addition of Wild Oats, with 110 stores in 24 states would dwarf the previous additions, though the store building and expansion program would continue. Whole Foods intends to remake its competitor, while gaining heft in important markets such as Florida where Wild Oats has eight stores as compared to Whole Foods' five, and the metropolitan Portland, Oregon area where Whole Foods had a single store compared to the six Wild Oats operates. Not surpris-

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ingly, Wild Oats' greatest concentration of stores is in California (32) where Whole Foods also is most represented (40 stores).

Wild Oats locations are smaller and less sophisticated than what Whole Foods presents, and skeptics think that will prevent Mackey getting what he expects from them. We're willing to see how he remakes the Wild Oats stores. If the acquisition survives, Mackey certainly has the chance to boost that chain's anemic margins, which are poor not only in comparison to his own company's but even to mainstream grocers. For example, last year Whole Foods had Gross Margins of 37.7%, Operating Margins of 8.5%, and Net Margins of 3.6%. Wild Oats came in respectively at 32.2%, 3.6%, and 1%. Whole Foods had a Return on Equity of 14.5%, while Wild Oats hit 10.7%.

BROWSE WHOLE FOODS

How does Whole Foods work? Consider the rollout late last month of the 40,000 square foot store located in the recently opened Center at Halsted, a hub for Chicago's gay community, whose high-discretionary-income residents with an interest in health are perfect buyers for the fresh and packaged foods. The Halsted store, slightly smaller than most new Whole Food Markets, meets the location profile for those other stores: 200,000 people with an emphasis on college-educated residents within a 20 minute drive: An audience for whom healthy food—not necessarily organic food—is enough of a priority that they are willing to spend more for what they perceive as an investment in better health.

In addition to health, Whole Foods is selling convenience to its busy clientele and is just as well prepared to fill your stomach on the spot as it is to fill your pantry at home. There's pizza, sushi, hot seafood, a carving station, vegetarian and vegan cuisine, an espresso, coffee and tea bar, a gelato stand offering more flavors than any shop in the neighborhood, an "enomat" that pours one-ounce servings of 16 varieties of wine available for sale in bottles, and, of course a full range of fresh fruits, vegetables, meats, poultry, seafood, staples and canned and frozen foods.

It's not just the variety the store offers—you can buy all of these things at my local Safeway—but the detailed, upscale way these foods are presented. It's not that you can buy a pizza at the new store. No, you get

a brick-oven pizza. It's not just that sushi is available. No, you get it prepared from scratch by a chef. Whole Foods might be an even bigger threat to local restaurants and take-out joints than it is to grocers, since prepared foods have the highest profit margins. The new Chicago store, located within a community center, enhances his vision of his markets as a "unique third place, besides the home and office, where people can gather, interact and learn while at the same time discovering the many joys of eating and sharing food."

Rather than the advertised-specials driven model we associate with conventional supermarkets ("pile it high and sell it cheap"), Whole Foods draws in shoppers who buy selectively what fits perceived benefits, and then might go across the street to buy the rest at a traditional market. Hence, Whole Foods does not need to rely on heavy print advertising to keep shoppers flocking to its stores. Word of mouth works just fine. For example, last year Whole Foods spent just \$24 million on self-funded advertising to generate \$5.6 billion in sales or 0.43% of sales, while Safeway spent more than triple that percentage.

Groceries are a relatively thin-margined business, and every dollar siphoned off to getting customers in the doors—and that usually means enticing them with constant sales—comes right off the bottom line.

Whole Foods is counting on wealthy countries' consumers' willingness to spend more on food as part of a healthy lifestyle. Americans when compared to citizens of other prosperous countries are in a position to spend more on their groceries. U.S. shoppers spend the smallest portion of household income on food in the world (10.1% as of 2005), while in the United Kingdom consumers spend 60% more, in Germany 30% more, and in Canada 20% more. In fact, though healthy eating and/or the avoidance of chemicals and other additives in what we eat is now emerging in this country as a major concern (and marketing theme), Europeans demonstrated the same concerns even earlier.

Critics wonder whether even if consumers are willing to spend more on healthier food, are they prepared to pay Whole Foods' prices? Mackey knows it. He occasionally notes that his stores are derisively called "Whole Paycheck." But Whole Foods is working on that too. The company puts produce and other items on sale, advertises those sales on a store-by-store basis

Whole Foods' best-of-breed reputation and know-how provide a formidable advantage against competitors... Mackey and his markets are riding a wave of public concern about the quality of what we eat that should carry WFMI back to faster earnings growth and a higher stock price.

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on its website, and, most importantly, has expanded its “365” brand, a store-branded line of non-perishable natural and organic food products, which are priced below national brands.

SLOWING OR JUST RESTOCKING?

Whole Foods had been racking up an average annual increase in sales of 18.2% since 1992, and over the previous five years as the company grew year-over-year growth remained a robust 15%. Cash flow had increased over the company’s history at a 22% annual rate and 16% since 2000. Earnings had grown at a 32% year-over-year clip and 23% since 2000.

But the June quarter of last year WFMI disappointed expectations based on such growth. Though quarterly earnings were up 21% and company wide sales increased 18% for the quarter, same-store sales rose only 9%, the first time that had happened in three years, and suggested Whole Foods no longer could count on getting greater revenues out of its existing stores, and would have to rely on building new markets to keep the company growing. The following quarter revealed the same pattern. And for the first time in years, quarterly profits were lower than in the previous year. Furthermore, earnings for the entire year were projected to inch up by less than 2%. Though most observers acknowledged consistently higher sales and cash flow, much of that cash flow now was making a detour from the bottom line over to expanding existing stores and building new ones. Over-expansion, of course, has been deadly for other large chains: Wal-Mart, Home Depot, McDonald’s, all were hurt by mindless building of new stores. In Whole Foods’ case, we do not believe they have come close to saturating their markets.

WILD OATS

Whole Foods operates in the self-described business sector “natural foods supermarket,” which really has very few players beyond itself, Wild Oats, Trader Joe’s, a privately held chain, and a disparate pack of very small local competitors. The FTC is opposing WFMI’s acquisition of Wild Oats because it takes too seriously the notion that there really is a business segment that consists of “natural foods supermarkets,” and contends the combined chains would be anti-competitive.

In fact, the “natural food supermarket” chains that are self-identified as such are just a variation on the supermarket we all know except they have decided to

market themselves as the place to go for healthy foods. There is absolutely nothing that prevents Safeway or Krogers from challenging Whole Foods for this market segment either by introducing similar products to their existing stores, which they have done, or by creating entire stores to mirror what Whole Foods does.

When Safeway recently listed its primary competitors in its major markets across the country, it mentioned Whole Foods and Trader Joe’s in Northern and Southern California, where Whole Foods has 21% of its 186 stores. Were Whole Foods to acquire Wild Oats, it is true it would dominate the “natural foods supermarket” niche, but that hardly means the combination would itself be beyond competition. Wild Oats has 29% of its markets in California. Were the two companies combined, they would have a total of 72 existing stores throughout the state where they have their biggest concentration of markets. Safeway at the end of 2006 under its various identities operated 507 stores in the state. If Safeway considers Whole Foods and Trader Joe’s competitors, does that not tell anyone paying attention—even the FTC—that “natural foods supermarkets” are just a segment of the supermarket business, and from that perspective Whole Foods plus Wild Oats would constitute merely a modest—but admittedly well focused—player? We expect the federal court now hearing the FTC case to decide in a couple of weeks. With or without Wild Oats, Whole Foods will do fine.

WACKY MACKEY?

John Mackey, the CEO, from the start has been a superb albeit quirky showman not only for his stores but also as an evangelist for healthy food. Whole Foods is an admirable corporate citizen, and, though the company is non-unionized, it is considered one of the 100 best companies in America for which to work. 94% of all options granted in 2006 were granted outside of the senior executive suite, and senior executive salaries are capped at 19 times the company’s average annual wage. For his part, Mackey set his annual salary at \$1.

When word broke in the midst of the FTC attempt to thwart acquisition of Wild Oats that Mackey, under the cloak of a screen name, for years had been dueling online with critics of Whole Foods not only was he embarrassed but he also found himself under SEC scrutiny. We doubt anything will come of this. In fact, the mischievous online comments provide a guileless glimpse of exactly how Mackey sees his company, and

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should be taken seriously. The single best instance is a message he posted on June 25, 2004: “[I] believe that what is really happening with the stock is that some really smart institutions are finally realizing what I realized many years ago: Whole Foods Market is going to be a really large company someday. They will hit their \$10 billion sales target by the end of the decade (probably before then) and they won’t stop there. It will double to \$20 billion 4 years after that (18% CAGR) and probably double again from there to \$40 billion within 5 years of then. The entire food retailing segment is undergoing a huge transformation. Wal-Mart is going to dominate the low price side of the business and Whole Foods is going to dominate the quality/service/healthy side of the business. Those companies stuck in the middle — Safeway, Kroger, & Albertsons — have huge labor union problems that aren’t going to go away, but are likely to only get worse. The future has never looked brighter for Whole Foods than it does right now.”

Some say Mackey should give way to a more professional CEO who can manage a huge corporation. We disagree. Mackey, though quirky, has demonstrated he knows how to translate vision into profits. But were Mackey to withdraw, there is a deep reservoir of senior executives to replace him, who with one exception worked their way up from store manager to the executive suite, another reflection of why employees are in most instances in harmony with management.

Though Whole Foods is willing to spend to grow, Mackey has not been willing to borrow to do it. Whole Foods' long-term debt amounts to lease obligations on equipment in stores (about \$300,000) and convertible debt (\$8.3 million). In short, spare change, and exceptional for a grocer of its market cap. Most supermarkets carry significant debt levels. Safeway, for instance, lugs around \$5.2 billion in debt, roughly a third of its market value.

Whole Foods has been using cash flow not just to build new stores but to buy back shares, a good idea when share prices are depressed. In 2005, it started a \$200 million buyback to be completed over the following four years, of which half was expended at an average price of \$49.85, well above where WFMI now trades. Another \$100 million target has been set up since then. If management thought that paying \$50 a share last year represented a rational use of cash, we can only presume that management had been snapping up shares when they were \$36 just three weeks

ago. Certainly the exercise price for outstanding options issued to employees (\$48.82) suggests the company is motivated to bring the share price up to a more respectable level.

VALUATIONS

The best mainstream grocers such as Safeway and Krogers trade at price ratios that make WFMI look pricey. However, if you accept our premise that Whole Foods is not just in the grocery business (and its profit margins suggest just that), then the price ratios start to make more sense. Safeway, which is smaller in market cap than Krogers but more profitable, has a gross profit margin of 31.3%, an operating margin of 6.4%, and nets 1.9%. Whole Foods gross margin is 37.7%, operating is 8.4%, and net is 3.6%. Those numbers are just off the scale for a grocer, and look more like what casual dining restaurants produce. No other U.S. grocer of comparable size commands such a net margin, though Winn-Dixie, which recently emerged from bankruptcy, for the moment comes in at 4% on net margin.

With Whole Foods experiencing a rapid return to respect since hitting \$36, price ratios have risen back toward their historical averages, and no longer are at their historical average lows. Price to Sales stands just below 1, Price to Cash Flow is 16.6, Price to Earnings 33.2, and Price to Book 3.7.

SUMMARY

Whole Foods had been cast aside by its bulls disappointed by a few subpar quarters. Perhaps their skepticism might pan out: Whole Foods might be outgunned by the bigger supermarket chains. Perhaps the entire natural/organic food movement will go the way of the hoola-hoop. However, we are willing to wager that Whole Foods’ best-of-breed reputation and know-how provide a formidable advantage against competitors. Certainly the balance sheet says it is strong, and given that its profits each year steadily increase in relation to fixed expenses (in 2006 the coverage was 7.5 times), Whole Foods seems admirably managed. Mackey and his markets are riding a wave of public concern about the quality of what we eat that should carry WFMI back to faster earnings growth and a higher stock price. We are willing to bet also that the Wild Oats acquisition will happen. Buy WFMI up to \$48. **SA**

Portfolio Updates

Price drops were almost universal since the last letter, but less deep among the largest cap stocks. The S&P 500 was off 6.4%, however if you break down that performance by looking at the 25 largest-cap and 25 smallest-cap names, the results present a starker example of how size over the last month has mattered: The largest-cap (\$186.7 billion on average) S&P names were down only 3.8% , while the smallest-cap (\$2.1 billion on average) names plummeted 17.7%. The *Sound Advice* portfolio fit the same pattern. Our stocks have a median market cap of \$12.7 billion and an average cap of \$40.5 billion, which means that we own more smaller and mid-cap than large cap companies. On average, the prices of positions in our portfolio were off 8.3% over the same period. Below we list the current market cap of each position discussed.

We are not in the business of sugarcoating difficulties, and as tempting as it might be, we won't start here. Our portfolio is built for long-term profits, and we absorb shots such as the past month's as the price of our discipline. During panicky runs, it's rarely a good idea to dump even damaged stocks. Depending on how you are wired, it might be a good time to take advantage of others' fear. This is hardly the first time Wall Street has shuddered.

The July recommendation, **Odyssey Healthcare** (\$360.9 million), dropped 11% after providing modestly lower than expected earnings. Nothing has changed for ODSY's story. The same problems (Medicare reimbursement levels, costs of expansion) remain as do the same opportunities.

The portfolio's worst performance also followed a disappointing earnings report. **Getty Images** (\$1.9 billion), which leases rights to use images from its dominant library of photos and other visuals, reported earnings a nickel shy of expectations and racked down its projections for the year. Shares fell 35%. The problem, says management, stems from the popularity of cheaper images available on royalty-free discount sites. Getty now owns the largest such provider, iStockphoto, and by pioneering web-based access and distribution, Getty has opened itself to new competition. Professional-quality digital cameras at relatively modest prices in the hands of semi-professional photographers

are creating a tide of acceptable images suitable for much advertising. Their availability through online distribution sites such as iStockphoto lowers demand for Getty's higher-end, higher-margin products. Management now believes it will earn \$2.22 a share

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rather than the expected \$2.47. We always say that as long as the basic story line for a stock remains unchanged, we are content patiently to buy. In this case, the threat of royalty-free images is changing the story. Since we deal with the market as it is, the flattened price for GYI convinces us to recommend buying these humbled shares, though with a lower buy limit. We are moving Getty to our Aggressive subportfolio.

Insituform (\$432.2 million), the sewer replacement company, also disappointed but did it, as Odyssey, without changing the landscape. INSU tumbled 28.3%. The primary problem, slow demand for sewer work, persists. For companies like INSU that have significant fixed costs related to maintaining equipment and retaining trained workers, any drop in sales magnifies damage to margins and earnings. Were political leaders and bureaucrats responsible for infrastructure willing to commit funds to meet existing real problems of over-the-hill sewage and water pipes, INSU would be fine. But that day must wait, unfortunately, for a flood of local calamities. Meanwhile, a slowdown in new home construction removes another trigger for demand for Insituform's services.

Xerox (\$15 billion) reported fair to good numbers highlighted by higher sales but did not show the expected margin growth in its color printing division. Furthermore, sales of digital printing equipment, which is the industry's future, also faltered. At the same time, sales of black-and-white equipment slipped, which is no surprise, since XRX is banking on the expansion by color printing, which

Sound Advice Portfolio for August 2007

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$10.24	8.20%	\$11.50	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$41.45	0.27%	\$47.00	BUY
American International	AIG	NYSE	\$64.67	0.77%	\$75.00	BUY
Boston Scientific	BSX	NYSE	\$13.08	0.00%	\$16.00	BUY
Coca-Cola Enterprises	CCE	NYSE	\$23.68	1.01%	\$26.00	BUY
ConAgra	CAG	NYSE	\$25.97	2.77%	\$29.00	BUY
CSX Corporation	CSX	NYSE	\$47.00	0.85%	\$51.00	BUY
Disney	DIS	NYSE	\$33.16	0.93%	\$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$46.34	1.23%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	\$55.53	0.86%	N/A	BUY
Fastenal	FAST	NASDAQ	\$47.89	0.88%	\$50.00	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	\$17.46	0.00%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$24.51	0.57%	N/A	BUY
Honeywell	HON	NYSE	\$56.01	1.62%	\$64.00	BUY
Insituform Technologies	INSU	NASDAQ	\$15.84	0.00%	\$20.00	BUY
Johnson & Johnson	JNJ	NYSE	\$61.15	2.45%	\$69.00	BUY
Liberty Capital	LCAPA	NASDAQ	\$113.43	0.00%	\$130.00	BUY
Mattel	MAT	NYSE	\$23.04	2.82%	\$32.00	BUY
Microsoft	MSFT	NASDAQ	\$28.71	1.39%	\$34.00	BUY
Molson Coors Brewing	TAP	NYSE	\$82.69	0.99%	\$100.00	BUY
Newell Rubbermaid	NWL	NYSE	\$26.31	3.19%	\$32.00	BUY
New York Times Co.	NYT	NYSE	\$22.31	3.14%	\$27.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$11.00	0.00%	\$14.00	BUY
Perrigo	PRGO	NASDAQ	\$21.58	0.83%	\$23.00	BUY
Sara Lee	SLE	NYSE	\$15.53	2.58%	\$20.00	BUY
Schering-Plough	SGP	NYSE	\$27.26	0.81%	\$37.00	BUY
Sony	SNE	NYSE	\$48.00	0.45%	\$59.00	BUY
Sprint Nextel	S	NYSE	\$18.85	0.53%	\$24.00	BUY
Superior Industries	SUP	NYSE	\$21.20	3.02%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$21.18	0.00%	\$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$61.61	5.42%	N/A	BUY
United Parcel	UPS	NYSE	\$76.75	1.98%	\$82.00	BUY
Wal-Mart Stores	WMT	NYSE	\$46.07	1.45%	\$52.00	BUY
Whole Foods Markets	WFMI	NASDAQ	\$42.27	1.61%	\$48.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$58.78	3.16%	N/A	BUY
Xerox	XRX	NYSE	\$16.07	0.00%	\$21.00	BUY
Energy/Natural Resources						
American Cent. Gold Fund	BGEIX	800-826-8323	\$18.82	0.27%	N/A	BUY
Anglo-American PLC***	AAUKD	NASDAQ	\$26.74	3.66%	\$36.00	BUY
Coeur d'Alene	CDE	NYSE	\$4.09	0.00%	\$4.00	BUY
EnCana	ECA	NYSE/TSE	\$59.90	1.00%	\$75.00	BUY
Icon Energy Fund	ICENX	800-764-0442	\$37.06	9.07%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$41.26	3.88%	\$46.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	\$74.13	3.30%	\$87.00	BUY
Transocean	RIG	NYSE	\$100.77	0.00%	\$112.00	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	\$25.44	0.00%	\$30.00	BUY
Discovery Holdings	DISCA	Nasdaq	\$24.57	0.00%	\$27.00	BUY
Electronic Data Systems	EDS	NYSE	\$23.13	0.86%	\$30.00	BUY
Getty Images	GYI	GYI	\$31.62	0.00%	\$42.00	BUY
Liberty Global	LBTYA	NASDAQ	\$40.62	0.00%	\$50.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$30.79	1.89%	\$38.00	BUY
Mitsubishi UFJ Financial	MTU	NYSE	\$9.95	0.95%	\$16.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$6.02	1.66%	N/A	BUY
Symantec	SYMC	NASDAQ	\$17.87	0.56%	\$22.00	BUY
Time Warner	TWX	NYSE	\$18.62	1.18%	\$24.00	BUY
Western Digital	WDC	NYSE	\$20.33	0.00%	\$25.00	BUY

*Prices as of the market close on Friday, August 10, 2007

**Yield represents all distributions during current calendar year divided by share price.

***Reverse Split (91 shares for 100), change in ticker symbol, and special distribution of \$1.646 per old share.
BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT

Sound Advice Market Indicators for August 2007

must come at the expense of black-and-white. The company also made a significant acquisition of Global Imaging Systems, a large copying sales and service provider focused on midsize to small businesses' imaging needs. Xerox had a long relationship with GIS, and should benefit from expanding its marketing arm. The 19.3% decline in XRX seems not even remotely justified by events. It's an attractive buy.

The medical and healthcare sectors, you would think, might be more resilient if the market is worried about a slowing economy, did not play to form. In our own portfolio, only **Perrigo** (\$2 billion), the generic OTC and prescription drug manufacturer, performed well, adding 5% on no news but with expectations of an upbeat August 23rd conference call. **Schering-Plough** (\$40.8 billion), a stellar performer so far this year, lost 16% as it brought to market \$3.9 billion in securities consisting of new common priced at \$27.50 and convertible debt to pay for its significant acquisition of Organon. **Boston Scientific** (\$19.5 billion) in its quarterly report did not provide any surprises, merely confirming what we expected: Stent sales were down dramatically. Almost unnoticed in media coverage was the strong performance of Boston's endosurgical (minimally invasive) products. Our expectations for Boston Scientific depend on getting its Guidant acquisition right, and a lessening of the drumbeat

skepticism about stents. From a misery-loves-company view, we note that Dodge & Cox, which is respected for its prescient smarts, has started a position in Boston Scientific in the last couple of months, and like us, is underwater. Since the July letter, that water is 15% deeper. **Johnson & Johnson** (\$177 billion) did outperform the market, which means it lost only 3.6%. It is a definite buy not just because it didn't fall as far, but because it is priced right for value shoppers.

As for energy and natural resources, if strapped hedge funds are siphoning off profits from their successful positions to cover losses, natural resource stocks must have gone first. **Icon Energy Fund** dropped 9.8%, while the least affected was **EnCana** (\$45.1 billion) off 6.6%. Yes, oil dropped from \$78 to close to \$70, but this is in part a seasonal adjustment and comes after prices hit new highs. We remain confident that energy stocks are worth owning. Precious metals did not gain as a refuge during trouble, though they did perk up as we close this month's book. Note that **Anglo-American** (\$71 billion) declared a special \$1.64 distribution for their ADRs while doing a modest reverse split (91 for 100). There is also a new ticker symbol, AAUKD. Our advice is to pick and choose what fits your portfolio, expect the short-term to be extremely volatile, and to hold on. It's not time to bail. Rather it's time to go shopping. **SA**

The Sound Advice Market Indicators

The Diffusion Index of Lagging Indicators gives "Sell" signals when all of its individual lagging economic indicators rise above their respective levels of six months earlier. This reveals a strengthening economy and inflationary pressures ahead.

The Diffusion Index of Leading Indicators gives "Buy" signals when its individual leading economic indicators drop below their respective levels of six months earlier. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates.

If we had followed the signals from our modified Diffusion Indexes over the years, we would have done very well indeed. The results are shown above. Between each "Buy" signal and each "Sell" signal, the S&P 500

rose substantially without exception. The average gain was 32 percent, not counting dividends. On an annualized bases the gain was 17.1 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

During the intervening periods between "Sell" signals and "Buy" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased 6.8 percent during these times. On an annualized basis, not counting

dividends, the gain was a paltry 0.6 percent per year, a return that could have easily been beaten many times

(Over please ...)

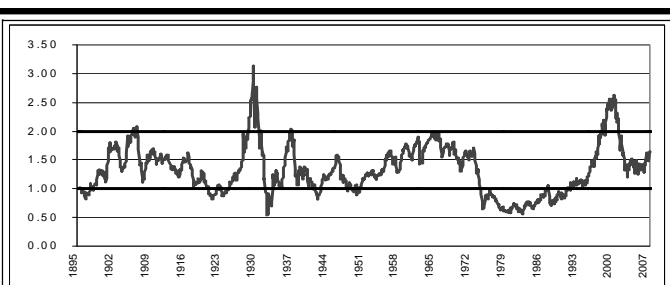
Buy Signals		Sell Signals	
Date	S&P 500	Date	S&P 500
Sep-69	94.51	Feb-69	101.50
Nov-74	71.74	May-73	107.20
Jan-81	132.97	Aug-77	97.75
Sep-85	184.06	Dec-83	164.36
Mar-89	280.00	Oct-87	280.16
Oct-92	415.10	Sep-89	347.33
Feb-97	798.38	Jan-95	464.72
Feb-03	841.15	Sep-99	1,383.60
Dec-05	1,248.29	Jul-05	1,234.18

Sound Advice Market Indicators for August 2007

over with safe investments such as Treasuries, short-term bonds or other low-risk investments.

To assess whether a market crash is likely after a "Sell" signal, we turn to the Risk Indicator. If the Risk Indicator is close to or above 2.0, we know the market is relatively high and contains a high degree of risk. This was indeed the case in September 1999 when the Diffusion Index of Lagging Indicators flashed a "Sell" signal and the Risk Indicator was (substantially) above 2.0. The peak came in six months, marking the end of the bull market as well as the peak of Supercycle Five. The market subsequently crashed. The S&P 500 dropped 39 percent until the next "Buy" Signal was given by the Diffusion Index of Leading Indicators in February 2003 (which was the exact month that bear market low point was reached). During that decline, most stocks suffered greater losses. The NASDAQ dropped nearly 80 percent.

Conversely, the market does not suffer lasting declines after "Sell" signals when the risk level is low. For example, the "Buy Signal" in November 1974 was one month from the bottom of that bear market, and came at a time when the Risk Indicator was below 1.0. Consequently, this "Buy" signal also marked the beginning of Supercycle Five. As the upward phase of Supercycle Five ensued and the Risk Indicator remained relatively low, the market did not experience lasting downturns after "Sell" signals. Instead, the bull run was merely interrupted with short declines, sideways movements, and sometimes even advances. Even the three-day decline in October of 1987, which became known as the "Crash of 87", was followed by a stampede of buyers snapping up bargains. I remember seeing individual investors lined up to invest outside discount brokerage offices because the phones were log-jammed with buyers.



The Risk Indicator tracks supercycles in stocks by comparing prices of stocks to real estate (house prices). A reading above 2.0 indicates times when stocks are extremely high relative to real estate. These are times when the risk is high and a supercycle is approaching a zenith. Conversely, a reading below 1.0 indicates stock prices are extremely low relative to real estate. At these times, the upward phase of a new supercycle is beginning. The current reading stands at 1.62.

However, as previously noted, when Supercycle Five reached its peak and the Risk Indicator climbed above 2.0, the decline was severe after the September 1999 "Sell" signal due to the excessive heights to which prices had previously been propelled.

We recommend remaining fully invested in the *Sound Advice* model portfolio at all times. We use the *Sound Advice* Market Indicators to influence our approach and nature of our recommendations. When "sell" signals are in force, our recommendations are more defensive in nature. We will be looking for special situations and are likely to recommend taking profits more readily. Conversely, during "buy" signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market averages. The chart below shows how *Sound Advice* recommendations have performed over time versus the S&P 500. **SA**

Since 1-1-2000

Sound Advice versus the S&P 500

An Investment of \$25,000 becomes:

Start Date	S&P 500		Sound Advice*		
	Annual Return		Final Value	Annual Return	Advantage Over S&P
From 1/1/2000	28,067	1.5%	\$59,212	12.0%	\$31,146
From 1/1/2003	44,975	13.6%	\$56,733	19.6%	\$11,758
From 1/1/2006	30,026	12.1%	\$33,885	20.9%	\$3,735

* These returns assume an equal amount is invested in all *Sound Advice* Model portfolio positions at the time of the initial recommendation.

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