



## The Shrinking “Long Run”

Low volume, investor apathy, a market that alternately terrifies with its volatility or bores with its back and forth action have discouraged most from participating in any way, but especially from making a long-term commitment to anything. In this tumultuous market, most investors focus on the short term, keen to know what will happen next, or even better, what will make them (or save them from losing) the most money tomorrow. If anyone tells you they have a method to determine short-term market moves, presume they either are inexperienced, deluded or felonious. As Benjamin Graham observed, “In the short run, the market is a voting machine. In the long run, it is a weighing machine.” But what is short or long term? In my lifetime as an investor, the market’s sense of both short and long term has compressed. In 1960 the average holding period for equities was more than eight years. A decade later, that had shrunk to five years. The trend has only accelerated. The NYSE says that as of 2010 the average holding period was six months. As for “short term,” it’s said (but it’s not true) that high frequency traders “own” the average stock for 11 seconds. Who knows what the real number is?

The reasons for this compression of holding periods are much debated. Some factors are mechanical. In 1960, you bought and sold stocks with high fixed commissions through your broker. Transaction costs of two or three percent of principal made the average investor pause before calling his broker. Today transaction costs are trivial, and just as important, for most investors there’s no broker to argue you out of doing whatever your impulse dictates. Just click and the shares are yours. Click again and they’re gone.

Then there is the rise of diversified investments: mutual funds, closed-end funds, ETFs, which involve even cheaper transaction costs. Then there is the 21st century’s velocity of information that stampedes both retail and institutional investors into short-term decisions. Finally, there are investor expectations, which in the 1990s bull market considered annual returns of close to 30% to be average. Consciously most investors have abandoned these distortions, yet such fantasies still haunt many who are quick to dump shares that don’t outperform immediately.

2011, a year marked by extreme day-to-day volatility, has further unnerved investors, but even with the number plus or minus moves of 2%, the benchmarks are back pretty much to where they began. Had you made a dramatic commitment to stocks by buying the pan-market Wilshire 5000 at their 2011 highs in early May, you’d be down 8.7%. Had you gone all in when the Wilshire bottomed on October 3, you’d be up 14.3%. Nobody catches either the top or the bottom, but in miniature these extreme results illustrate a much larger theme: how 1960s style long-term investing combined with a willingness to buy during down markets, can be extremely profitable. As my favorite investment aphorism runs, “You make your best money in bear markets. You just don’t realize it at the time.” SA

We’ve all heard the line about an infinite number of monkeys at an infinite number of typewriters being able to produce down to the typos the 1623 folio edition of Shakespeare (and, of course, an infinite amount of gibberish). But if you were to ask whether that baboon peeling a banana at the local zoo, were he or she given a typewriter, would produce an exact duplicate of the 1623 folio edition of Shakespeare’s works, the odds would be astronomical, which brings us to the world of financial predictions and stock selection.

Never in the history of mankind has the average investor had access to more information and opinions than we do today, which paradoxically leaves most investors looking for a guide. Some investors seek that financial monkey who will churn out Macbeth, Hamlet and Twelfth Night. Invariably when they think they’ve found him, instead of “To be or not to be,” the chimp happily produces “F#sq2dfopiuj9ermd\$saf#.”

Other investors reject the very idea of outperforming the market, and put their portfolios into inexpensively managed index funds. There’s nothing wrong with that default position even though the oft repeated notion that markets are efficient and thus no one can do better than them is patently false. Others try following rapid fire advisors, to capture short-term profits by trading in and out, hoping that by not lingering, they won’t get hit.

There is, however, a saner path to identifying an advisor, and it comes down to this: figure out who you are as an investor and then look for someone who puts into words and decisions what makes sense to you. This is light years away from following whoever has the hot hand, or is the loudest voice or gets the most media exposure. If temperamentally you and your advisor are not in sync, you won’t keep with the plan. At *Sound Advice* the plan melds letting the business cycle determine the portfolio’s tone (aggressive in a poor economy, defensive in a hot economy), selecting out of favor positions and, when necessary, having the discipline to wait for the market to appreciate what you bought when it was unappreciated. None of this comes naturally.

*-Gray Emerson Cardiff*

### The SoundAdvice Portfolio

 **13.0%** Annual Return  
Since 1/1/2009

#### SoundAdvice vs S&P500

Since 1/1/2000  
\$25,000 becomes:

**\$72,014**  
With SoundAdvice

**\$26,522**  
with the  
S&P500



## Natural Resources

Over the last dozen years, natural resource shares have returned from the dead, and continue to play a pivotal role in how well *Sound Advice* has done. In this issue, we are refocusing this portion of the portfolio, dropping some positions (See Portfolio Updates on pages 5-6) and refreshing our views on what remains. To appreciate the profound change in market attitudes over the last 12 years, consider two emblematic commodities. Oil, which the much referenced 1999 *Economist* cover story predicted could drop to \$5 a barrel, instead now trades around \$100 and gold, which in that same year was languishing at \$254 an ounce and even five years later, having almost doubled, while the stock market had tanked, was ridiculed in *The New Yorker*, as “a collective hallucination.” Gold currently trades at \$1712 and earlier this year pushed through \$1900. Oil, the quintessential economic commodity and gold, which has limited utility but profound meaning as a store of value, both soared, and less dramatic commodities such as coal, iron, copper or zinc followed a similar jagged course higher. Don't expect the future to be any less messy.

But 2011 has been difficult for natural resources—most shares are under where they finished 2010—for two primary reasons. First, since early spring, investors have been preoccupied that the U.S. economy was backing into a second recession or worse. Pessimism about economic growth chilled interest in commodities. Second, European economic distress not only raised the likelihood of a renewed U.S. recession but also strengthened the U.S. dollar as an alternative to the Euro. Commodities, which are priced in dollars, when the dollar rises are cheapened.

But whenever the winds of opinion have shifted, and investors believed there was evidence that economic news did not point to recession and/or a stifling crisis such as Europe becomes less urgent, hopes for economic recovery revive, the dollar weakens and fast money floods back into commodities. Consider that on November 30th, when news hit that the world's major central banks had launched a lending program to help troubled European banks, that U.S. employment figures were solidly higher than expected and that China was loosening lending rules, gold, oil, copper, coal and pretty much everything else rocketed higher and took mining and energy shares with them. *Sound Advice* remains constructive about a global economic recovery.

**Agrium (AGU—NYSE)** Demand for fertilizers moves in tandem with food prices. Rising demand for food translates into rising demand for fertilizers. In a world that is losing arable land at the same time populations are increasing demand for fertilizers is on an upward swing. Agrium's

North American production facilities are located almost entirely in western Canada, where the costs for natural gas, the primary feedstock for producing nitrate-based fertilizers, are cheaper than in other areas of North America. There are plants in Argentina, which also enjoy a natural gas price advantage over competitors. Agrium also owns a network of retailers marketing fertilizers and other agricultural products in both North America and Argentina. More recently the company bought a retail chain in Australia that links its sales to demand for food in China. Thanks to the addition of these Australian stores, retail sales are up 56% this year. Lately, prices for its fertilizers have been very strong, though volume slipped along with confidence in how a less confident and cash constrained consumer base would respond to higher food prices. However, longer term demand for agricultural products will push prices higher.

The fertilizer business is geared to supply domestic demand because shipping costs are a critical pricing factor. Producers supply local markets primarily. However, this doesn't mean that global demand and supply issues are not a critical element in local market prices. Rising consumer demand, particularly in emerging markets, has ignited blazing demand for fertilizers to amplify production.

At current levels, AGU should be compellingly attractive to long-term investors who recognize that demand for food, probably more than demand for biofuels, will challenge farmers to maximize their production, which must benefit fertilizer producers. In terms of price ratios, Agrium trades at a distinct discount from its competitors, and in terms of Agrium's own history over the last decade the shares have not been this cheap with the exception of the Great Recession's 2008 results. There's a modest dividend, but you are buying AGU, because it is yoked to food demand.

More than many mining companies, **Anglo American (AAUKY—PK)** is tied closely to emerging economies, especially those of China and India. AAUKY is the world's fourth largest iron ore exporter, working from mines in South Africa and Brazil. Iron ore accounts for 38% of operating profits, its metallurgical coal mines in Australia account for 8% of operating profits, thermal coal production in South Africa accounts for 7% of operating profits, copper production in Chile accounts for 29% of operating profits, South American nickel mines generate 1% of operating profits, its platinum mines in South Africa and Zimbabwe account for 9% of operating profits, while diamonds as of 2010 accounted for 5% of operating profits. Other assorted mining businesses bring in 7% of operating profits. The diamond income should increase after AAUKY acquired

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the 40% interest held by the de Beers family. AAUKY now controls 85% of the diamond business with the other 15% in the hands of the Zimbabwean government.

Anglo has undergone a refocusing, selling off peripheral businesses and even its large position in the gold miner, Anglo Ashanti, in order to concentrate on coal and industrial metals. With the diamond deal, Anglo now seems to have assumed the shape management wants and is expanding production, primarily in South America, for coal, copper and nickel. The question is whether management preferred managing a more focused company, or is AAUKY setting itself up for eventual acquisition?

We like AAUKY for the very reasons it has lagged its competitors. Consolidation into a pure mining company has banished one of its problems, but it is also dogged by its concentration of assets in Africa where governments now and again consider companies with colonial histories as predators whose assets are not the sole property of the shareholders. However, the South African government, where most of AAUKY's mines are, has recognized that in other countries that have appropriated privately owned mines, the results have been economically disastrous.

Valuations put Anglo American ahead of its peers with significantly lower price to book, price to sales and price to cash flow. Only the price to earnings ratio is slightly higher. Compared to its own valuation history, Anglo currently is priced anywhere from half (price to earnings) to 85% (price to sales) of where it has traded over the last ten years. If commodity prices get back in gear, Anglo American is well positioned to prosper.

**Fidelity Select Natural Gas (FSNGX)** came into the portfolio in September 2009 just as natural gas prices were stumbling to levels not seen in more than a decade. Despite oil, after ballooning to \$148 a barrel, then collapsing to the low \$30s, more than doubling by that September before again retreating, natural gas prices could only muster a 50% rise from its bottom.

We thought that natural gas, considering its environmental superiority to oil and coal as well as its rock-bottom price, would play catch up to oil. Historically West Texas Intermediate Crude relative to Henry Hub natural gas has traded at about 10:1. The super-surge for energy in 2008 drove that ratio down to 6:1 as NG prices spiked even higher than did the price of oil. Today, that ratio is an astronomical 27:1. Were the historical ratio the measure today, natural gas should be trading at around \$9.77 per Mbtu. We thought (and think) that natural gas, even as fracking (use of hydraulic pressure to release natural gas and liquid hydrocarbons locked into shale) have generated new supplies, is ultra cheap at \$3.62 per Mbtu.

Yet natural gas remains cheap regardless of what we think, and were FSNGX a pure play on natural gas, its price would be weaker than it is. Instead, the shares have kept pace with other energy funds, because the manager, Ryan

Oldham, who took over last year, has larded his portfolio with companies with significant exposure to oil and liquid natural gas. Currently the two largest positions in Oldham's portfolio are Apache (11.5%) and Anadarko (10.3%). Apache derives 78% of its revenues from oil and 21% from natural gas, and its reserves are roughly 44% oil and 56% natural gas. Apache is putting more emphasis on oil and natural gas liquids over dry natural gas, since the former is far more profitable in the current market. Anadarko at the end of 2010 had 56% of its proven reserves in natural gas, 32% in oil and 13% in natural gas liquids. Also adding stability to the portfolio and a bit of income, FSNGX has about a 20% exposure to power utilities.

Were Oldham to see a market shift that valued natural gas more, he has the ability to refocus his portfolio back to pure natural gas companies and service companies tied more closely to nat gas. At other times, should prices for both oil and natural gas weaken, Oldham is able to overweight more defensive positions such as utilities and pipeline companies, whose revenues are more or less constant regardless of where natural gas prices go. If you think energy going forward is worth your investment dollars, FSNGX provides broad exposure with a kicker in natural gas.

**Transocean (RIG—NYSE)** has had a rough 18 months. First, the Macondo well disaster in April 2010 menaced RIG with huge liabilities, both civil and criminal, and the shares tumbled below \$43 in June. As Wall Street became confident that Transocean contractually was insulated from significant liabilities that anxiety dissipated, RIG shot back to \$85 in March. Then concerns over a moratorium on offshore drilling and weakness in its sector again damaged the shares as they dropped to \$45 this past October. But investors' attitude toward drillers began to improve as the moratorium was tempered and economic conditions, particularly in the U.S., improved. The shares reached \$60.

In the meantime, RIG agreed to buy a much smaller competitor, Akers, at a price that struck many as excessive, which triggered questions about the quality of the balance sheet and hurt the shares.

Concern over the balance sheet was not misplaced. In early November, management reported a poor quarter that featured too much of its hardware spending too long in drydock undergoing repairs as well as upgrades mandated in the wake of the Macondo spill. Then in late November, RIG announced it needed to float a bond offering and a secondary offering of 29.9 million shares at \$40.25 (See Updates on Page 6) to prevent its credit rating falling below investment grade. RIG today is a \$43 stock that, we believe, right now should be trading in the low \$60s, and eventually should trend toward \$100.

Our arguments are modest: demand for energy remains high, and despite the explosion in natural gas finds through fracking and other non-traditional methods, global demand for hydrocarbons will keep RIG busy. Transocean remains

the go-to deepwater driller not only because of its expertise but also because its fleet can perform pretty much anything a client requires, and when it can't, is able to go into the market to acquire or custom build a rig provided the contract is long and rich enough to justify the expense. Currently the backlog is around \$24 billion, day rates are rising back toward historic highs and we have every reason to believe that Transocean will regain its leading position.

There is one question, however, that has a short-term impact on the shares: the \$3.16 annual dividend, which RIG instituted in May. At that time, it represented a 4.7% yield, which has now ballooned to 7.3%. Given management concerns with the balance sheet, it's possible that the dividend is vulnerable to a cut or even elimination, which in the short term might hurt the shares. We expect that Transocean, if reduction or elimination happens, would be quick to restore the distribution at its earliest opportunity. By then, we believe, the shares would be well out of their doldrums. Right now, valuations are scraping levels we've never seen and suggest that it's a screaming buy—with or without the dividend—for aggressive investors.

**Tetra Tech (TTEK—NASDAQ)** TTEK had built its success—and it was a very successful company and stock for many years—on its design and engineering expertise in water reclamation and environmental cleanups. In the late 1990s, management fell under the spell of the telecom revolution, and began to acquire small to medium-sized companies that designed and installed fiber optic systems. When reality failed to meet expectations, TTEK cratered. We bought in when the stock traded at half its current price. As results improved, the shares almost tripled before succumbing to hard economic times that limited both corporate and government contracts. Most investors will need to see stronger U.S. government contracts before they rekindle their ardor for this company. However, Tetra Tech is well situated for that turn. Consider its most recent acquisition of PRO-telligent, which provides security infrastructure for the U.S. State Department and other agencies.

We think TTEK has much further to run for three reasons. First, of all our natural resources, water is both the least valued and the most important. Second, Tetra Tech has expanded its expertise in engineering into other lucrative sectors by buying up small companies that serve the mining, traditional energy and alternative energy industries. Finally, the company is taking its expertise abroad through acquisition of small companies that are similar to or complement Tetra Tech's own expertise. Currently about 30% of revenues are coming from outside the U.S.

Tetra Tech despite its policy of buying new companies maintains a handsome balance sheet with long-term debt at about 10% of its market cap. As for valuations, TTEK is cheap not only when compared to its peers but also to its own history. But we think the biggest potential business for

TTEK lies outside the United States in countries like China and India, where environmental concerns have been at best an afterthought. Only now are their governments starting to calculate the costs of neglecting environmental regulations. As governments around the world make this a priority, Tetra Tech should be a prime beneficiary.

**The USAA Precious Metals & Minerals Fund (USAGX)** has a remarkable record, outperforming the average precious metals fund for nine of the last ten years by following a relatively simple strategy: own well-managed low cost producers. The fund's senior manager, Mark Johnson, keeps portfolio changes relatively stable. The average precious metals turns over its portfolio at an 83% clip. USAA Precious Metals & Minerals Fund changes its holdings at around 24%. Though Johnson does not jump around, he does change the portfolio's emphases depending on market conditions. Thus, though he likes smaller and mid-sized miners, when their prices run up, as occurred over the last year when larger mining companies went shopping for new reserves by buying up smaller companies, the fund benefits but Johnson does not then double down on what he then comes to consider overpriced small companies. Instead, he gravitates toward mid to large miners. Thus, when Kinross acquired Red Back Mining, an African miner, USAGX enjoyed a significant boost to its NAV. At present, the fund's single largest position is Canadian Goldcorp followed by Newcrest, a largish Australian mid-sized firm.

The fund has relatively small exposure to silver, which Johnson had prudently avoided as it shot above \$50 an ounce, far outpacing gold prices, before collapsing. The fund also has some exposure to platinum. As for industrial metals, there is no exposure. Finally, as opposed to some funds that mix bullion with mining shares, Johnson is uninterested. He notes that miners over time have moved at two to three times the pace of bullion (that works on both the upside and the downside) because rising bullion prices should magnify the value of miners' reserves. However, this year that has not been the case, especially when gold pushed above \$1900 an ounce while mining shares just stood around. We concluded that the divergence reflected a buying panic as global investors believed the world was on the verge of Armageddon and demanded hard assets rather than the paper gold mining shares are printed on. Longer-term investors clearly did not believe that gold could hold the \$1900+ level, so they did not push mining shares with the same passion. For now, they were right.

We like USAGX for its long-term outperformance, and will continue to hold it as an anchor against what remains a volatile economic and political background that despite currently artificially low interest rates eventually will experience significant inflation and a weaker dollar, both of which augur well for gold and gold miners. **SA**

## Portfolio Updates

Were the 2011 market set to music, all we'd hear would be the same notes played over and over: sharp rises and falls resolving into silence. The last couple of months gave us both directions with October being the sharp upswing, followed by a week or so of small back and forth moves culminating in a vigorous run higher that began the Friday after Thanksgiving. Shares are back where they were at the start of November, which is more or less where they finished 2010. Since the last letter, with the exception of the Dow, which eked out a 0.3% rise, the S&P that slipped 0.7%, the Nasdaq 1.2%, the Wilshire 5000's 1.5%. The *Sound Advice* portfolio, thanks mostly to natural resource positions, was off 2%.

The November Five for 2012 did not get off to an auspicious start, dropping 5.4% as two positions, [AHS](#) and [Transocean](#), misfired. The AHS story is simple: small cap stocks, especially the smallest, are volatile. AHS had outperformed in the October rally (+26%), and in the November downdraft outperformed in the same outsized way— except to the downside (-11%). Nothing has changed here. Volatility will prevail regardless of how well the shares do over time. Our thesis, as stated in the November issue, remains: “AMN by far is the biggest company in this very fragmented industry, and as the demographic tsunami of aging baby boomers surges through the medical care structure, demand for nurses, physicians, pharmacists and medical support staff will expand. Employers will need the flexibility firms like AMN provide when it comes to meeting those demands.” Nor has our buy limit changed, which currently stands at \$8. Transocean, however, has news, which we did not expect. The problems affecting these shares, though we see them as fixable, have reduced what had been the premier deepwater driller to a more flawed proposition.

First there were a couple of headline issues. In mid-November at a well off the coast of Brazil that Transocean is drilling for Chevron, there was a minor oil spill, which reminded the market of BP's Macondo well catastrophe that began in April 2010 with the destruction by fire and explosion of RIG's Deepwater Horizon platform in the Gulf of Mexico. Though Transocean is insulated legally from the environmental costs of the Macondo spill, that event and the subsequent drilling moratorium off the U.S. coast hurt business and put a cloud over the company's shares. After that, concerns over what a global recession might do to RIG's revenues has hurt. But that is just the business

cycle at work.

The Chevron spill is trivial compared to what happened at the Macondo well, but has led to the Brazilian government fining Chevron and suspending it from drilling activity until the government is satisfied with the energy company's explanation. Chevron has accepted publicly all responsibility for the incident. Then off the Newfoundland coast, a Maersk supply ship collided with a stationary Transocean platform, which put an above-the-waterline hole in a support column, dropping this RIG ship out of commission for an undetermined period. We expect RIG will be compensated by Maersk for repairs and lost income.

These are the sorts of events that happen, and do not bring into question Transocean's underlying soundness. Other events have challenged our still positive attitude

### Fund Considerations At Year End

**As the year closes, keep two things in mind. First, if you are thinking about picking up mutual funds as the trading year comes to a close, remember that December is the favorite month for funds to make distributions of long and short-term capital gains. For instance, [USAA Precious Metals and Minerals Fund](#) just paid out \$3.84. Share prices are adjusted to reflect such payouts but for shareholders who buy shares in standard accounts rather than in IRAs, 401(k)s and other tax-deferred accounts, these distributions are to be avoided, since they will be taxed regardless whether you've owned the shares for the entire year or bought them the day before they went ex-dividend. Before you buy funds in a standard account, talk to the funds or ask your broker whether a significant distribution will occur before the end of the year. If they answer is yes, wait till the ex-dividend date has passed before making your buy. For tax-deferred accounts these payouts are a wash.**

toward Transocean. RIG floated a secondary offering of 26 million shares (plus another 3.9 million shares that the underwriters could choose to buy) at \$40.50 a share. This will put \$1.6 billion on the balance sheet to be used to cover a tender offer for \$659 million in a busted convertible preferred and to eliminate short-term debt taken on when it acquired the Norwegian driller Aker, a decision that has drawn wide criticism not so much about Aker's assets but more about how much RIG paid for them. Given that RIG's book value is \$62, the secondary offering was dilutive. Whether the secondary offering combined with a debt issue strengthen the balance sheet enough to keep the dividend intact is in play, though our sense is that management will try to defend the full distribution. However, our focus is the likelihood of an extraordinary rebound in share price once the market gets over this year's rough treatment. Though we don't enjoy losing money, we're willing to absorb pain when we believe we can recoup and then some. RIG still holds this sort of promise.

[Commonwealth REIT](#) performed in line with REITs of all classes, which weakened and then recovered some of those losses as investors worried about the consequences

of any disruption in the credit markets should European banks falter. Since the last letter CWH is off 4.1%.

**Xerox**, the fourth of the quintet, drifted down 0.6%, on no news. The backoffice business is doing well and XRX now is the dominant digital printing company. As costs come down for color digital printing, Xerox also is best positioned to capitalize on color's compelling superiority to black and white. If the economic healing process is allowed to work globally, Xerox should show outsized performance.

**Paychex** is the lone positive performer (+2.2%) over the past month as the market digests improving U.S. employment numbers and rising consumer confidence. PAYX's reporting calendar is one month behind those of most U.S. companies, so it will be announcing results next week. Based on everything we see, we anticipate the numbers will be encouraging. Of course, trying to handicap how Wall Street will respond in the short-run to results, even good results, is a tricky game. We'd take a longer view, and expect PAYX will do very well in any recovery.

The same surprisingly strong consumer confidence numbers reported last week pushed up several positions that depend on freer spending. **International Speedway**, the race car track owner, added 3.7% on hopes that more confident consumers will return to watch NASCAR events and leave more money behind for food, beverages and collectibles. **CarMax**, the used car seller, increased 9.7%.

As noted above for CommonWealth REIT, investors did not treat REITs well this month. Hence, **CGM Realty Fund** slipped 1.9% and **Associated Estates**, the apartment REIT, lost 7.4% as apartment REITs, which ever since housing and the economy went south have enjoyed the best performance among all real estate subsectors, saw a retreat even by the largest (Equity Residential). **Retail Opportunities**, the strip mall REIT, announced a secondary offering (7.47 million shares priced at \$10.85 a share), a significant discount from where the shares had been trading before the announcement (\$11.78). Shares have regained about half of that, closing at \$11.30. ROIC will use the cash both to zero out its short-term debt, in particular its \$175 million revolving line of credit and especially to fund new acquisitions. Stuart Tanz, whose history at Pan Pacific shows he knows the west coast strip mall market, continues to add properties he sees as under managed. After all the back and forth, ROIC since the last letter is off 1.3%.

We are selling several positions in a continuing effort to trim the size of our portfolio. In the natural resources subportfolio, we are saying farewell to **PowerShares Water Resources Fund**, which has been unable to make its holdings reflect more closely its stated purpose: water resources. We sympathize with the manager's dilemma: water is the most undervalued and yet the most essential natural resource but there are not enough companies with water resources as their core, which has meant that the ETF has to rely on larger industrial companies that derive a portion of their revenues from water. We'd prefer to own

straight water-related positions such as **Tetra Tech** and straight industrial firms like **Honeywell**.

We are also purging financial services from the portfolio by selling **Davis Financial Fund**. Though at some point financials will work again as investments, we've concluded that financial firms are black boxes whose moving parts are beyond our understanding. Yes, the same could be said, for instance, of biotech, about which we are not competent to make company-by-company evaluations and yet we continue to hold through **Hambrecht & Quist Life Science Fund**. But even in high-risk biotech startups, one can believe the interests of the management and the shareholder overlap. We can't say the same about bankers. Our exposure to financials henceforth will be limited to what the guys at **Leucadia** do in their portfolio, which, by the way, just added a meat packer to its assets.

We're also selling **Plum Creek Timber**, which has served us well and remains an excellent income investment with a 4.7% yield. Now that we own **Masco**, which is directly tied to the same housing market that PCL reflects, we think that it has a greater chance at outperformance as the economy recovers.

**Molson Coors** has been with us for several years, and done well, but we'll let someone else profit when eventually TAP gets bought by SABMiller, currently its partner in MillerCoors.

**Mattel** also has worked well not only as it dug out of the original problems that made it attractive to us but also as a solid performer during the so-called "Lost Decade." At this point, we think it's realized its value for us.

Finally, we are selling the **Third Avenue Value Fund**, whose portfolio has become essentially a family of Asian holding companies tightly yoked to real estate. Though these companies might be screamingly undervalued, that concentration concerns us. We'll let the **Dodge & Cox International Fund** provide international diversification.

In a worried market, healthcare can serve as a safe harbor. But some provided more than just relatively quiet anchorage. **Hambrecht & Quist Life Science Fund** (+5.2%) went ex-dividend but also is benefitting from continued merger and acquisitions activity among its holdings as larger companies buy promising drugs rather than spend to develop them. **Pfizer** (+2.9%) plays that game, but this month's rise owes more to institutional investors belatedly wanting to own PFE now that Lipitor, its flagship statin, has lost patent protection. Even **UnitedHealth**, the HMO, whose sector many fear will be hurt by federal budget cuts, added 4.1%. **Johnson & Johnson** was flat, though **Stryker**, even after announcing it would boost the quarterly dividend to 21.5 cents from 18 cents as well as buy in another \$500 million in shares, dropped 3.4%. **Boston Scientific** lost 9.5% on no significant news but likely worsened by year-end tax selling as disappointing performers absorbed a further shove down. **SA**

Income With Growth	Symbol	Exchange	Price *	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.65	4.35%	\$18.25	BUY
CommonWealth REIT	CWH	NYSE	\$16.71	11.97%	\$22.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$11.30	4.25%	\$12.00	BUY
Diversified Growth						
CarMax	KMX	NYSE	\$31.15	0.00%	\$34.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$26.03	2.37%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$22.68	1.99%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$30.70	3.24%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$101.70	1.27%	N/A	BUY
Fastenal	FAST	NASDAQ	\$42.05	1.69%	\$44.00	BUY
Honeywell	HON	NYSE	\$54.00	2.47%	\$60.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$25.38	0.63%	\$30.00	BUY
Johnson & Johnson	JNJ	NYSE	\$64.53	3.53%	\$71.00	BUY
Leucadia National Corp.	LUK	NYSE	\$23.26	1.07%	\$30.00	BUY
Masco	MAS	NYSE	\$9.39	3.19%	<b>\$10.50</b>	BUY
Mattel	MAT	NASDAQ	\$28.73	3.20%	N/A	<b>SELL</b>
Microsoft	MSFT	NASDAQ	\$25.70	2.49%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$41.40	2.32%	N/A	<b>SELL</b>
Paychex	PAYX	NASDAQ	\$30.06	4.26%	\$35.00	BUY
Pfizer	PFE	NYSE	\$20.56	3.89%	\$23.00	BUY
Stryker Corp.	SYK	NYSE	\$47.85	1.50%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$16.35	3.91%	\$22.00	BUY
Third Avenue Value Fund***	TVFVX	800-443-1021	\$41.14	2.35%	N/A	<b>SELL</b>
Time Warner	TWX	NYSE	\$34.60	2.72%	\$40.00	BUY
United Parcel	UPS	NYSE	\$72.45	2.87%	<b>\$76.00</b>	BUY
UnitedHealth Group	UNH	NYSE	\$48.91	4.25%	\$53.00	BUY
Wal-Mart Stores	WMT	NYSE	\$58.32	2.50%	\$64.00	BUY
Xerox	XRX	NYSE	\$8.16	2.11%	\$10.00	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE/TSE	\$68.72	0.32%	\$100.00	BUY
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$19.24	0.00%	\$25.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$31.06	0.18%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$35.99	4.67%	N/A	<b>SELL</b>
PowerShares Water Resources ETF	PHO	NYSE	\$16.98	2.37%	N/A	<b>SELL</b>
Tetra Tech	TTEK	NASDAQ	\$21.98	0.00%	\$28.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$34.51	11.11%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$4.46	0.00%	\$7.00	BUY
Boston Scientific	BSX	NYSE	\$5.34	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$24.71	0.00%	N/A	<b>SELL</b>
H&Q Life Sciences Fund	HQL	NYSE	\$11.58	7.51%	<b>\$12.20</b>	BUY
Maxim Integrated	MXIM	NASDAQ	\$25.61	3.44%	\$29.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$16.15	11.47%	\$20.00	BUY
Symantec	SYMC	NASDAQ	\$16.19	0.00%	\$22.00	BUY
Tellabs	TLAB	NASDAQ	\$4.16	1.92%	\$5.50	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$10.17	8.77%	N/A	BUY
Transocean	RIG	NYSE	\$43.26	0.00%	<b>\$60.00</b>	BUY

\* Prices as of Friday, December 9, 2011

\*\* Yield represents all distributions during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.

\*\*\* Note ticker symbol changed to TVFVX

BUY, HOLD, SELL OR LIMIT IN **BOLD** INDICATES A CHANGE IN ACTION OR LIMITThis table has live prices, charts & buy limits on our website: <http://www.soundadvice-newsletter.com/members>

The rising swell of home foreclosures began in 2007 as a symptom of faltering real estate markets across the country. But as the swell turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US and worldwide economies. Indeed, the state of the nation's real estate markets and the economy have become one and the same. Clearly, the recession cannot be fully put behind us and a recovery kick into full gear until the inventory of foreclosed homes stops overhanging the market.

We have seen all this before. It was back in the 1980s. After years of loose and questionable lending practices, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate onto an already-depressed real estate market. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts. The crash was worse in some parts of the country, but the damage to the whole US economy was substantial. Does this sound familiar?

We have the same situation today. It's like the old good news/bad news jokes, except this is no laughing matter. The bad news is that today's crash has been damaging to both real estate prices and the national economy.

The good news is that we have the tools to determine when the bad news will be over. This will give us a tremendous opportunity not only to invest in real estate for pennies on the dollar at the right time, but also in other investments as well as those that benefit from a recovering economy.

**The Key Indicator**

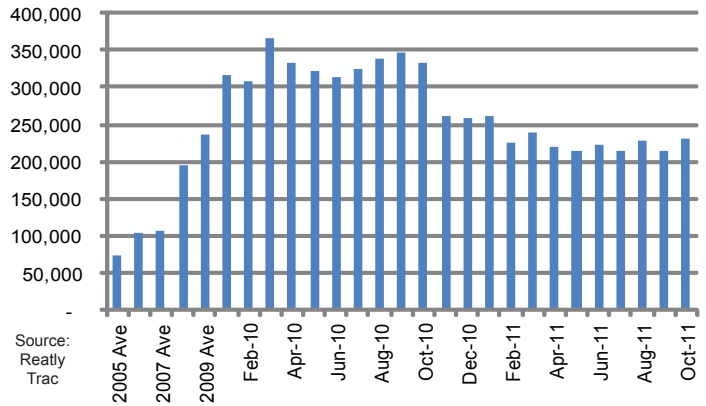
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive data base. You can access foreclosure information on local markets from their website [www.realtytrac.com](http://www.realtytrac.com). We use some of their data here to gauge the state of the nation and its real estate, and plan to continue to do so in future issues of **SoundAdvice**.

What we are looking for is a significant decline in the number of foreclosures. When this happens, the bulk of the overhanging inventory of foreclosed properties will have been digested, and the real estate recovery can then begin as well as in the economy. In the late 1980s, this was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began. For nearly two decades, fortunes were made from real estate purchased for pennies on the dollar during the S&L Crises of the 1980s.

The following chart shows US foreclosure rates. In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the 2010 fourth quarter. At first, the decline was due largely to a freeze in foreclosures by several major lenders. The downtrend continued as Federal and state foreclosure prevention efforts allowed distressed homeowners to stave off foreclosures.

**US Foreclosure Rates - Monthly Averages**



These efforts have included mortgage assistance programs for the unemployed and mediations that have been resulting in loan modifications.

**Dissecting the Foreclosure Process**

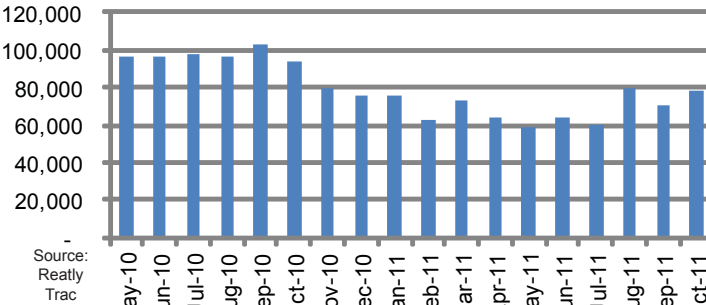
It's important to keep in mind that the foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures is actually the aggregate of the number of properties in each of these three stages.

We can get an early glimpse of a change in trends by focusing on changes in the first step of the foreclosure process: new default filings. After all, a significant change in the first step of the foreclosure process must ultimately lead to a significant change in the aggregate number.

The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month. However in November they began declining and dropped to a low of 58,815 in May, and July was almost that low at 59,516.

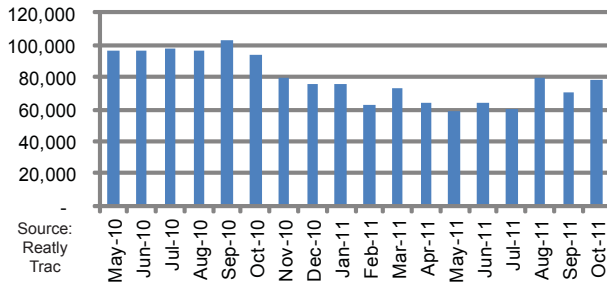
However, in a marked turnaround, August new default filings leaped by 33 percent, to 78,880. Although new default filings declined ten percent in September, they increased again in October to 77,733. These latest readings, reveal that the crisis will be getting worse in the immediate future.

**US New Default Notices**



Further confirmation comes from our largest state, California. Below is a chart of new default notices there.

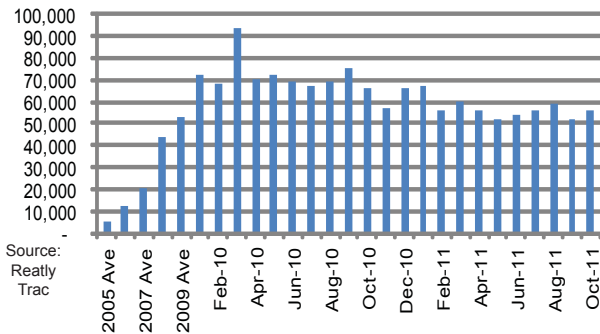
**California New Default Filings**



For the month of August new default notices in California jumped a whopping 55 percent. Although they declined in September by 13 percent, new defaults in California erased the decline in October by increasing to 29,240.

The chart below shows all stages of the foreclosure process in California ( including auctions and bank repossessions).

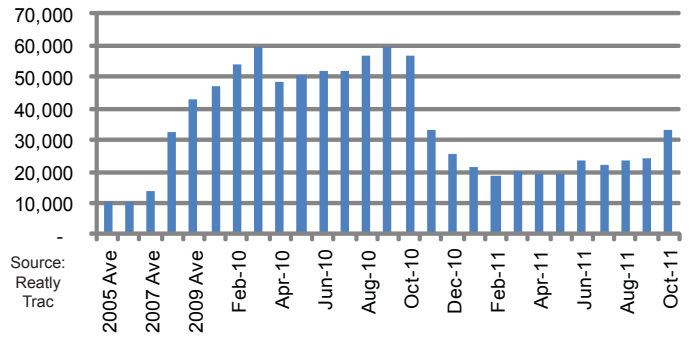
**California Foreclosures - Monthly Averages**



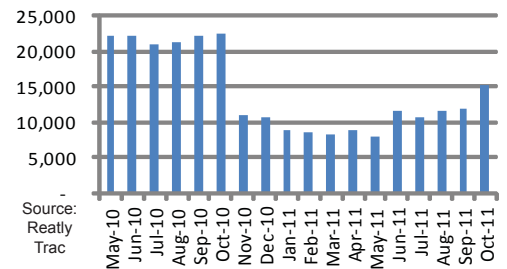
In 2005, California foreclosures averaged 5,138 properties per month. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Foreclosure rates were declining until August when they rose 5.7 percent to 59,383. However, we know from the high amounts of new default filings recently that foreclosure rates in California will be climbing in the months ahead. This is significant because one fourth of the nation's foreclosures have been in California for the last few years.

Florida is the next highest foreclosure state with 14 percent of the nation's foreclosures. Foreclosures climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the rate dropped sharply. See the following chart:

**Florida Foreclosures - Monthly Averages**



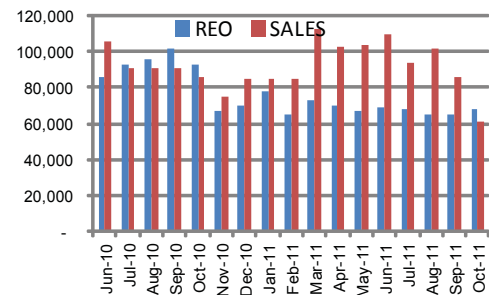
**Florida New Default Filings**



However, foreclosure rates jumped by 37.4 percent in Florida during in October. As an indication of what lies ahead, new default notices have been increasing during the last four months, and jumped by 28 percent in October.

**The Inventory**

At the other end of the foreclosure process is what the banks have not been able to sell. This inventory is called "real estate owned", or REO for short. Each month more REO



is added to the inventory. However, each month there are a number of properties sold from the inventory. Above is a chart of the REO (in blue) and sales (in red) during the last year.

On balance, there has been 270,269 more properties sold than have been added to the REO inventory, or 19.6 percent of the inventory of 1,379,529 foreclosure properties currently listed for sale. While there is progress, there is still a significant amount of inventory to go.

**Conclusions**

The recent increases in new default filings is evidence that lenders are starting to push through foreclosures delayed by past bungling (robo-signing) and moratoriums. That means the crisis will be getting worse before it gets better.

We will be tracking foreclosure metrics closely both nationally and in key states in these pages of **SoundAdvice** to be among the first to know when the end of the foreclosure crisis is at hand. Stay tuned.

## Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool a "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the Risk Indicator will rise over the line

marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$7,383,706 in stocks and to \$1,129,255 in houses.

But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$293,471,981, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying Real Estate Investment Trusts (REITs.) Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, REIT shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

### The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.46. This reading reveals that stock values are about 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 renew your subscription.)



## Business Cycles and Stocks: The **SoundAdvice** Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be (1.5)/3 or 50 percent.

When the Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

**The Diffusion Index of Leading Indicators:** As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators 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.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. The current reading of the Diffusion Index of Leading Indicators is 50 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

**The Diffusion Index of Lagging Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which would reveal an overheating economy with immediate inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 66.7 percent.

### Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual average return of 22.3 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent during caution periods.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the **SoundAdvice** Diffusion Indexes and their track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)

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