



“Greed is good,” exclaimed Gordon Gecko in the movie *Wall Street*. The Bible talks about “cupiditas,” but less warmly. Were I translating the Bible for bankers, I’d turn “cupiditas” not into just “love of money,” but also “love of credit.” I’ve lately been reading a book about economic collapses. *It’s Different This Time* concludes that “[E]xcessive debt accumulation, whether it be by government, corporations or consumers often poses greater systemic risks than it seems during a boom.”

As I read, the face of Lloyd Blankfein, Goldman Sachs’ CEO or of Jamie Dimon, the CEO of JPMorgan Chase, floats across the page. In testimony before the Financial Crisis Inquiry Committee, Blankfein implied the crisis was an act of nature, comparing financial disasters and how bankers prepare for them to hurricanes and how communities prepare for them. It was an unwise comparison, since Phil Angelides, the committee chairman, responded that hurricanes are acts of god, while acts of men created the financial crisis.

Dimon wanted to transfer the real responsibility to ineffective regulators and, like Blankfein, framed 2008 as just one of those things that blows through now and again: “It’s not a surprise; we know we have crises every 5-10 years. My daughter called me from school one day and said ‘Dad what’s a financial crisis’ and without trying to be funny, I said, ‘It’s the kind of thing that happens every 5-7 years.’ And she said, ‘Then why is everybody so surprised?’”

Dimon might lament failed regulators, but he said nothing about how bankers disarmed those regulators, gamed them and ignored their own excesses until it all imploded, thus creating even more opportunities. JP Morgan now owns Bear Stearns and Washington Mutual, both felled by the financial crisis and both acquired with federal assistance.

But we too can make money from those excesses. If you doubt that, go to Page 3.

-Gray Emerson Cardiff

What Do We Know?

2010 started well, at least until January 19th, after which stocks, ours included, got pummeled. It looks much like 2009: January in both years was a disappointment, though we might feel this January’s sting more if only because 2010 follows a very successful year, whereas January 2009 just extended more of the punishment 2008 had served up. *Sound Advice* had an excellent 2009, and, as we’ve been not shy to tell you, the so-called “Lost Decade” for us produced 11% annualized performance. In part, we succeeded thanks to our indicators, in part we succeeded in what we chose to invest in, in part we succeeded because of luck and, in part—perhaps the largest part—because mostly we avoided what we did not understand, especially when it got too expensive. My ears still burn at what some subscribers said when cancelling their subscriptions after we observed in late 1999 that Cisco, though an excellent company, should be trading in the mid-teens and not at \$75. We missed nearly entirely the tech bubble on the way up and on the way down. We missed mostly the financial services bubble as well. We try, as best we can, to stick to our knitting. We are always fully invested.

“There are old mycologists and there are bold mycologists, but there are no old, bold mycologists,” a mycologist, that is, a mushroom expert, observed at dinner one night when another guest fretted about the sautéed wild mushrooms being served. A gray beard, our host, made clear that though there are risks if you forage for your table, none is so significant that you should forego plucking chanterelles from the forest floor—provided you know what you are doing. Know what you are looking for and don’t pick what you don’t know. It’s easy enough to endorse this common sense approach, but less easy to avoid an insidious variation: Don’t flatter your ego by convincing yourself you know something you don’t know.

Yesterday, a TV ad on CNBC skillfully traded on

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

\$68,689

with **SoundAdvice**

versus

\$21,788

with the

S&P 500



that crucial self-deception. A commodity trading company ad, set in an airport, has an attractive businesswoman walking up to a male colleague staring at his laptop screen. He sighs. It's not an email telling him he needs to divert to Scranton, rather he's looking at his brokerage statement, and tells his friend "I really need to diversify." With a winsome smile she announces there's more than stocks to invest in: "I invest in commodities." But he's resistant. Says he, "What do I know about pork bellies?" Now if the ad ended there, I'd conclude it was a public service announcement right up there with artful warnings about smoking, drinking, texting while driving or gambling. Instead it continues. She dismisses his reluctance, reminding him "You know about gold right? Crude oil?" and reminds him that "It's a pure price play," which to her means you don't have to worry about P/E ratios or CEO scandals. He is intrigued. She plugs the advertiser, and then the voice-over invokes the brokerage's tag line "Commodities are everywhere."

My first reaction, was to worry that if Wall Street is marketing commodities to retail investors, then perhaps we're getting toward the end for commodities. But then the advertiser's duplicity sunk in. If you are overwhelmed by investing in stocks—and after the last decade most investors are still reeling—commodities are hardly going to simplify the process. No CEO scandals? I could tick off several high profile scandals that impacted commodity prices. Remember BRE-X, a Canadian gold mining company that supposedly had hit a monster find in Indonesia that until its chief geologist "fell" from a helicopter unraveled into a scam? Or how about the copper market, which plummeted after a Japanese trader at Sumitomo turned out to have been fudging his reports and grossly distorting the market? Did Enron create an entirely fictitious market for broadband? Do OPEC and other producers collude to distort the price of oil? Do refineries shut down for "maintenance" at inconvenient times to push gasoline prices up? Remember the Enron traders chortling over how they were socking it to "Granny,"

by getting power generators to shut down? As for P/E ratios, commodities trading has more than its share of jargon, statistics and gibberish.

But most important, what does that guy at the airport or his seductive colleague really know about gold or oil? Sure, the spot price for gold and crude oil is on the TV and radio and we see how the price of gasoline changes as we pass the local gas station. Is being familiar the same as understanding? I don't think so.

The ad appeals because it offers the devil you don't know, commodities, in place of the devil you do, stocks. Most investors, both professional and retail, have suffered through a very rough decade. They learned that many CEOs put their own interests ahead of their shareholders and that the projections financial advisors had shown them about how their assets would grow and be ready for harvest at retirement turned out to be built on flawed models and woefully meager data. Remember in the late 1990s that the average investor expected over the next decade 27% annualized performance? Some had never experienced a severe bear market, and presumed that their very limited experience of the post-1982 bull market was normative. Hadn't those assumptions worked last year, last month, last week? Don't smirk about how foolish retail investors can be. The exact same stupidity played a crucial role in what destroyed Bear Stearns, Lehman Brothers and AIG, and almost took the entire credit market to hell. Their senior executives relied on models developed by astrophysicists working with limited data and assumptions.

Investing, since it always confronts the future, involves unpredictables. *Sound Advice's* success to date relies on applying straightforward valuation models to businesses we reasonably can understand regardless of where the market's emotions take investors, and then having the patience to wait for better times. So far, so good—even when the market, as it periodically must, is in decline. SA

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For Your Inner Vulture

During the 2009 rally, most of the biggest winners were companies that in the bear market's darkest moments were considered—fairly or feverishly—likely candidates for bankruptcy. Consider General Growth Properties, a woefully overleveraged shopping mall REIT whose shares on March 2, 2009 traded at 33 cents. Once the panic subsided, share prices for such companies rocketed. Today, still in bankruptcy since last April, those shares trade on the Pink Sheets for \$9 as management tries to restructure its debt.

When General Growth does emerge from bankruptcy, something will be left for shareholders, but those least worried today are General Growth's creditors who as Wall Street panicked, snapped up the REITs' debt at pennies on the dollar, and stand to reap a combination of new debt and/or equity in REIT's post-bankruptcy reincarnation. Last year, the scarier the debt, the better the return. As the manager of the fund we are recommending this month notes in his September letter to shareholders, "the high-yield [debt] market returned 49% and the lowest-rated CCC debt issuances returned more than 90% in 2009...." What connects the lowest credit-rated companies, despite being able to survive 2009, is their current crushing debt loads. And the most endangered are those companies acquired between 2005 and 2007 in leveraged buy outs (LBOs) during a buying orgy enabled by cheap credit. Expect more defaults, more bankruptcies and more opportunities.

If economic moralists continue to drone on about greedy, unsophisticated home buyers' reliance on dodgy mortgages, what can be said about supposedly sophisticated financial lions whose "strategies" in LBOs stood on two legs: "borrow as much as you can because the costs are nearly zero," and "we can flip this within a year?" Debt for LBOs invariably starts out as high-yield, and is a staple for high-yield funds. There have always been junk bond mutual funds. *Morningstar* lists 558 bond funds (all classes) with "high" in their names. Last year, as a group they averaged a 43.8% return with the best sporting an 86.8% increase.

But most funds manage sprawling portfolios. Consider that *Morningstar* says the average portfolio among the high-yield funds it tracks holds 266 positions. Portfolios this large might offer diversification, but the

very size suggests their managers have no conviction about anything except to gain exposure to high-yield assets and pray.

We have another idea, a mutual fund that was rolled out at the end of last summer and is too new for *Morningstar* to give it a full description: **Third Avenue Focused Credit Fund (TFCVX)**. It aims to hold no more than 70 companies' debt. Yes, we instinctively mock Wall Street for fabricating funds to capitalize on retail investors' appetite for trendy themes such as tech in the late 1990s and natural resources in 2005-2007. Institutional and retail investors now are keen on junk bonds. But Third Avenue is hardly new to distressed debt investing, and those running it, rather than rushing to capitalize on a marketing opportunity, have reason to expect ample investment opportunities.

Third Avenue

We confess we are biased toward this family of funds. *Sound Advice* currently recommends its flagship fund, the **Third Avenue Value Fund**, and in the past has owned its Small Cap Fund and its International Fund. Each outperformed their market segments while in our portfolio, and was sold only when the fund closed to new investors, which at *Sound Advice* automatically triggers a sell.

All Third Avenue funds hew to a common discipline that Martin Whitman, who founded the firm, developed in his career as a vulture investor. In the standard popular treatment of investing in distressed companies, Hilary Rosenberg's *The Vulture Investors*, Whitman is a central character, who when he first came to Wall Street homed in on two areas no respectable investment banker would touch: bankruptcies and stockholder litigation, which went hand in hand, since owners of equity and debt in troubled companies' assets needed to go beyond the dry figures in SEC filings and bankruptcy proceedings to understand such companies' real worth. Occasionally they have to litigate their points.

Whitman capitalizes on several factors. First is Benjamin Graham's "Mr. Market" syndrome," in which investors are always too emotional about current circumstances, either anxious to sell the securities

of troubled companies for too little, or to buy the securities of prosperous companies for too much. This impoverishing instinct, especially in the case of troubled or bankrupt companies, is particularly severe among debt holders, who by nature are risk averse. Second, Whitman is better than most in ferreting out from balance sheets, notes to SEC filings and other sources what assets a troubled company has to meet its credit obligations and has a sharp sense of how the economy, as it moves through its cycle, favors certain industries. From experience, he can sketch out different restructuring scenarios, and based on their likelihood take positions in the company's securities.

In building the team to manage the Focused Credit Fund, Third Avenue has installed Jeff Gary as manager. Gary, with 20 years of experience analyzing distressed debt, came over from BlackRock where he led the distressed assets team overseeing a \$17 billion portfolio. He is supported by six other credit analysts, who average 13 years experience with distressed debt. Furthermore, Gary works within the Third Avenue family, which encourages interchange among its portfolio managers, all of whom understand these assets.

Gary, as an example of how the various Third Avenue managers can collaborate, mentions Energy XXI (2.1% of the portfolio). "The idea came from our team, Curtis Jensen [manager of the Small Cap fund and now TA's Chief Investment Officer] performed the research and we bought the bonds into the Small-Cap Fund and the Focused Credit Fund. This enables us to leverage the entire investment team and platform to benefit our investors."

In tracking the **Third Avenue Value Fund** during the 2008 bear market, we expected an increase in the fund's exposure to distressed debt, and Whitman did not disappoint. In his most recent letter to shareholders (<http://www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-09Q4.pdf#TAREX>), he outlines the significant profits harvested from his distressed debt positions. One example is CIT, in which the "Fund acquired the CIT Notes on the theory that there was about a 10% to 15% probability that CIT could succeed in a voluntary exchange; and an 80% to 85% probability that CIT would have to reorganize in a prepackaged Chapter 11 Reorganization. As expected, the voluntary exchange failed and on November 2009, CIT filed for Chapter 11 Relief with a

pre-packaged Plan of Reorganization. TAVFX seems likely to do okay with its holdings in a reorganized CIT – new bonds and new common stock." Our only question was when Third Avenue would troll out a vulture fund dedicated to debt.

Third Avenue Focused Credit Fund

The fund debuted on August 31st, almost six months after distressed debt prices bottomed along with pretty much everything else. Gary concedes disappointment that the fund was not in place to reap those post-March 9th gains, but Third Avenue funds never have been market timers and are always focused on the long term. More to the point, Gary expects the coming few years to offer a bumper crop of troubled corporate debt that Third Avenue's "deep dive" style of analysis is uniquely able to exploit. Not only was the volume of new high-yield issues from 2003 to 2007 huge and the subsequent default rate high, but even those borrowers who were able to avoid bankruptcy by arranging new loans bought time but did not increase their ability to survive. Using research from J.P. Morgan, he shows that "high-yield defaults occur on average 3.8 years following the issuance of lower-rated debt [to replace it]." During the first nine months of last year, \$121 billion in new high-yield debt was issued, most of it to refinance other debt that was maturing, and most of that was issued at even more onerous rates and with lower ratings than the paper it replaced, which sets the stage for future distresses.

It's hard to believe that in coming years we will see anything like what is estimated to have been 2009's \$193 billion in defaulted debt, but the numbers will be substantial. Looking back on the 2001-2002 recession, defaults started rising in 1999 and held at their peak for 2001 and 2002, which accounted for \$12.7 billion in defaults in a market that looks puny compared to what developed between 2005 and boomed into 2007. Defaults in this cycle jumped from \$4 billion in 2007 to \$49 billion in 2008, which 2009's crop has swamped.

Value Investing in Distressed Credits

Third Avenue's approach to equities starts with an insistence on "safe and cheap." Like any value investor, TA seeks stocks selling at a steep discount to what it gauges the underlying company is worth. What has always distinguished Third Avenue's equity analysis is an ability to extract from SEC filings and

other documents not just numbers but what those numbers mean. The TFCVX portfolio ranges across all classes of debt from publicly traded bonds to bank debt to convertibles and to debtor-in-possession (DIP) infusions to companies in bankruptcy.

It took the irresponsible credit markets of 2005-2007 that not only let private equity investors overpay for whatever struck their fancy but also stripped away from their loans many of the traditional covenants that in the past had imposed responsibility on borrowers. Whitman believes such laxity has created the opportunity of a lifetime for distressed debt investing and with leverage in these deals averaging 6.7 times equity he has all the elements necessary to launch a distressed credit fund.

Aside from the most important asset the fund comes into the world with, Third Avenue's essential skills in distressed asset investing, TA's new fund confronts investors with no legacy problems. The fund manager can build the portfolio from other people's mistakes, which allows him to buy assets with an increased margin of safety.

Unlike common shares, which always stand last in line when a company must reorganize either in or out of bankruptcy, debt comes in innumerable forms with very distinct degrees of claim on a company's assets. As Gary points out, when he holds a senior secured bank loan that has first claim on assets and he can buy it at a big discount from the issuer, he is in a far better position than a manager who owns anything junior to his secured loan.

Note the fund's name "focused credit," which makes clear that unlike most funds, whether bond or equity, the number of positions will be highly concentrated. In the initial SEC report, Third Avenue recorded 41 positions, and management intends to concentrate on no more than 60-70 companies. Why, says the manager, should he use anything more than his fund's best ideas? As we noted, most high-yield funds hold three to four times TFCVX's upper limit.

That's fine provided Gary gets it right. Focused portfolios soar when the managers get it right, but a few missteps would be painful. The fund tries to balance market and credit considerations in making its selections. Hence, the portfolio contains securities that on several levels combine offense and defense. Any stock investor understands what defensive

sectors are (healthcare or utilities, for example, will continue to do good business regardless of the economic climate) and what offensive sectors are (energy or retail, for example, which do well during times of economic growth but stall during recessions). As of its initial report, the portfolio in terms of sectors is weighted toward early recovery asset classes: almost 18% is in energy and mining and 8.6% in financials, areas that Third Avenue's funds believe are undervalued at present.

However, for debt investors, though how a company's revenues respond during hard and good times is important, when it comes to less than investment grade securities even more important is how precarious the specific company is and how secure a piece of paper is relative to a company's other credit obligations and assets. This is where Third Avenue is best at gauging and balancing offense and defense.

Third Avenue analysts have an advantage over their competitors and, in particular, over rating agencies such as Moody's or S&P, the quality of whose research was laid bare during the subprime debacle. Interestingly, when asked for an example of a position TFCVX holds that rating agencies underrate, Gary mentioned the debt of Fortescue, in which **Leucadia**, whose smarts *Sound Advice* appreciates, also owns a large debt and an equity position.

Gary divides his portfolio into five segments that range through Performing Bonds and Loans (companies have a low probability of default), Stressed Performing Credits (companies have a higher level of uncertainty, but the fund limits its risk by owning only over-secured bank loans or unsecured short-term bonds with a 24 month or shorter maturity), Capital Infusions (Debtor in possession loans to bankrupt companies and exit financing, which is senior to other debt but involve companies in flux), Distressed Performing Credits (Third Avenue's research believes the probability of default is lower than Wall Street consensus) and Debt-for-equity Restructuring either done in court or out of court. The fund reports that as of the end of its first month, 36% of assets were in Performing Bonds or Performing Bank Loans and 36% in the more risky last three classes (the balance is in cash). Gary expects that as the fund deploys that cash the fund will shift depending on the credit market and economic environments. Expect to see a maximum of 75% in riskier credits when the market is

most stressed, and as little as 25% when it is placid.

Let's look at some examples along this risk spectrum. At the low risk end are credits like the second lien HCA PIK 9.625% notes due 11/15/2016, which constitute 2.7% of the portfolio and are among the most widely held securities in high-yield funds. HCA went private in an LBO in 2006. This debt is secured by HCA's assets, but more importantly HCA generates about \$1 billion in free cash flow, which can be used to buy down debt or expand the company. The prospect of the owners taking the company public again would provide more protection for the bondholders.

A less secure business, Swift, the trucking company, whose debt is considered stressed but performing, was taken private in May 2007. Before the LBO, Swift carried \$332 million in debt. The LBO put \$2.94 billion in new debt on the balance sheet. Third Avenue owns first lien bank loans secured by most of the company's tangible assets. When acquiring the debt, Third Avenue anticipated, indeed, looked forward to Swift shortly being in technical violation of its loan covenants. Were that to happen, Swift would have to renegotiate its terms, which it subsequently did, increasing interest on the loan from LIBOR plus 325 basis points to LIBOR plus 835 bps. In addition, Swift also paid its lenders a fee to facilitate the deal. Third Avenue believes that once the U.S. economy stabilizes, Swift's national truck line will return to profitability further enhancing the value of its debt. Should Swift not recover, the value of its fleet, terminals and other assets would protect Third Avenue's investment.

A notch higher in risk are "distressed performing credits," an example of which is Third Avenue's \$7.9 million (face value) investment in Marsico Capital's First Lien Secured Term loan that matures in December 2014. Marsico is an advisor to several fund families such as Columbia and Russell and runs its own stable of funds. Until its founder reacquired Marsico in an LBO in mid-2007, it was a division of the Bank of America, which had bought the part of the firm it did not own in 2000 at a total cost of \$1.1 billion. The LBO price was \$2.7 billion. The timing was terrible. In 2008 and 2009 both cash flow and assets under management tumbled. Worse, the banks that underwrote the loans were unable to unload all of the

debt Marsico used and was all too happy to sell it at sharp discounts to buyers like Third Avenue.

Moving further out on the risk spectrum is Debtor-in-Possession (DIP) financing an example of which is paper from Aleris International, which ranked 413th on the Fortune 500 roster for 2009. An industry leader in rolled and extruded aluminum products, recycling and specifications alloy manufacturing, Aleris went private in a late 2006 LBO and filed for bankruptcy less than three years later. DIP financing arises when companies in bankruptcy require cash to continue operations. Such loans usually are short-term and become senior to all other obligations, which in Aleris' case means that Third Avenue's \$4.3 million investment in the \$500 million loan that matures next month carries minor risk.

Then there is CIT, one of the last major financial services companies to fall into bankruptcy. Here the Focused Credit Fund has bought into DIP financing that will result in an equity and debt position after it exits from bankruptcy.

Third Avenue will make its best profits not from high yield performing debt, but from lower rated investments that depend on its analysts being able to unfold not just the subtleties of existing assets needed to service debt but also the possible scenarios should the company have to reorganize. In fact, the most lucrative outcomes could result from taking positions in companies that Third Avenue expects to go into bankruptcy. Look at CIT or Swift as examples. We're secure in letting Third Avenue make such choices.

Third Avenue should be very busy over the next few years. Among the JP Morgan charts Third Avenue provides, one tracks lower rated debt issuance alongside default rates between 1995 and late 2009. The pattern is clear. During boom times with interest rates low, issuance spikes and defaults dwindle. Thus 1996-1998 and 2003-2007 saw few defaults amid rapid expansion of risky debt, and 1999-2002 and 2008-? is witnessing a flood of defaults.

We recommend TFCVX not as a bet-the-ranch position, but a timely investment tool among many. That this fund has just debuted should not discourage you from considering using it. For individual investors the minimum investment is \$2500 in both standard and tax-deferred accounts. SA

If history is any guide, Third Avenue should be very busy over the next few years. During boom times with interest rates low, issuance spikes and defaults dwindle. Thus 1996-1998 and 2003-2007 saw few defaults amid rapid expansion of risky debt, and 1999-2002 and 2008-? is witnessing a flood of defaults.

Portfolio Updates

Since January 8th, when the portfolio was priced for that issue, the market, after peaking on the 19th, declined anywhere from the Dow's 5.7% to the techcentric Nasdaq's 7.6%. The S&P and the pan-market Wilshire 5000 indexes, better gauges of the overall market, lost 6.9%. *Sound Advice* did not escape, dropping 7.8%. The constant question for any investor when the market turns rough, should I stay or should I go, runs through our minds. Our Indicators continue to show Buy, so the answer is "Stay." Our best evidence remains that even after the pounding stocks have taken since last month, *Sound Advice* still is up 35% since the start of 2009, and has produced an annualized return over the last decade of 11%. As we observe in our cover essay, the same instincts that keep us in the market now have produced the results you can see on that chart on the front page.

As we've noted in our online posts, earnings season, though on the whole providing excellent and often better-than-expected reports, unless the company also promised even better results for coming quarters, punished any cautious or pessimistic guidance. The worst instance was **Tetra Tech**, which beat analysts' expectations but worried about future quarters, and went so far as to lay off some employees until they had a better read on demand. The primary problem is slow commercial and real estate related projects. Then there is its wind energy component, which got everyone excited when oil was at \$147 a barrel, but has lost most of its momentum when oil slipped under \$40. At current prices, the passion for alternative energy projects is becalmed, but not totally dead. TTEK is seeing early state feasibility studies, which augur well should these projects move from planning to implementation. Nonetheless, expectations were too high. Shares dropped sharply that day, and since the last letter are off 23.9%. We're happy to be buyers while TTEK is weak.

International Speedway, January's recommendation, suffered a similar fate. The shares got hammered after its conference call as investors reacted not to how well ISCA is doing in keeping costs in line

but to how the analysts themselves had miscalculated how long it would take for ISCA to get up to speed. The eternal problem for value investors is that we can recognize companies that are going through a difficult period, understand that the problems are temporary, and as is the case with ISCA, imagine ways in which



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the company could be better than it was even in good times, and still not have a clue about when any of this will happen. The irony for International Speedway is that the very conditions necessary for its tracks to return to better revenues and profits are beginning to emerge: the recession itself seems to be on the wane, and even if job formation, which is crucial for NASCAR's fan base to spend, has not yet gained traction, consumer confidence is picking up. We have no problem with International Speedway's progress.

When management does knock the ball out of the park and predicts more of the same, the results can be just as extreme. **Perrigo**, the OTC generic drug and food supplement company, announced it had nearly doubled profits for the quarter. Helping boost top and bottom line results were its line of generic prescription salves and ointments as well as its active pharmaceutical ingredient division, where sales to other companies such as Teva Pharmaceuticals exploded. Perrigo, which we recommended at \$26.50 last June after it had been a big winner for us earlier in the decade, has been favored during the recession as shoppers recognized they could buy store-branded products with the same efficacy as national brands but pay 30% less. Yes, the recession has drawn value-driven consumers away



This table is updated with live prices, charts & buy limits on our website:

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

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$6.77	7.09%	\$7.20	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$58.93	0.19%	\$72.00	BUY
Boston Scientific	BSX	NYSE	\$8.21	0.00%	\$12.00	BUY
CarMax	KMX	NYSE	\$20.34	0.00%	\$27.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$19.62	2.93%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$29.85	7.54%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$93.07	1.96%	N/A	BUY
Fastenal	FAST	NASDAQ	\$41.99	1.67%	\$50.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$17.32	1.91%	N/A	BUY
Honeywell	HON	NYSE	\$37.47	3.23%	\$46.00	BUY
International Speedway Corp.	ISTA	NASDAQ	\$25.47	0.55%	\$31.00	BUY
Johnson & Johnson	JNJ	NYSE	\$62.64	3.13%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$21.95	0.00%	\$30.00	BUY
Mattel	MAT	NASDAQ	\$20.10	3.73%	\$23.00	BUY
Microsoft	MSFT	NASDAQ	\$28.02	1.86%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$41.22	2.33%	\$52.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$14.67	0.00%	\$18.00	BUY
Perrigo	PRGO	NASDAQ	\$45.29	0.49%	\$48.00	BUY
Stryker Corp.	SYK	NYSE	\$51.06	0.78%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$13.96	4.58%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$20.79	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$42.44	2.69%	N/A	BUY
United Parcel	UPS	NYSE	\$57.20	3.15%	\$70.00	BUY
UnitedHealth Group	UNH	NYSE	\$32.54	0.09%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$53.45	2.04%	\$60.00	BUY
Xerox	XRX	NYSE	\$8.47	2.03%	\$10.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$18.00	0.00%	\$25.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.00%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$36.41	4.61%	\$43.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$15.55	0.51%	\$19.00	BUY
Transocean	RIG	NYSE	\$83.99	0.00%	\$100.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$31.50	0.03%	N/A	BUY
Aggressive Growth						
AOL Inc.	AOL	NYSE	\$23.65	0.00%	\$28.00	BUY
Comcast	CMCSA	NASDAQ	\$15.42	2.46%	\$21.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	8.49%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$41.95	7.27%***	\$45.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$9.74	0.00%	\$10.42	BUY
Liberty Global	LBTYA	NASDAQ	\$24.30	0.00%	\$28.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$17.66	4.53%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$17.14	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd****	TFCVX	800-443-1021	\$10.55	1.12%	N/A	BUY
Time Warner	TWX	NYSE	\$27.03	2.81%	\$34.00	BUY

* Prices as of Friday, January 8th, 2010

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

*** Dividend Deferred

**** Covers distributions from Aug 31 - Dec 31, 2009

BUY, HOLD, SELL OR LIMIT IN BOLD INDICATES A CHANGE IN ACTION OR LIMIT

from national brands, but we don't think the popularity of Perrigo's OTC products will disappear entirely once the economy has recovered. Since the last letter, PRGO is up 19.9%.

The themes unnerving the market are several. China has begun to restrain bank lending, but our own economy, as reflected in employment figures, is moving in fits and starts. One day the numbers are discouraging, and the next they are the opposite. GDP came in at 5.7% for the quarter, better than expected, and several other measures of productivity and demand were also encouraging. However, Wall Street investors were most absorbed with chaos in the Euro as Greece stumbled over its huge deficit and the possibility it could default on its sovereign debt.

This in turn unnerved investors about Spain and Portugal, to say nothing of the eastern European members whose economies also absorbed huge amounts of borrowing earlier in the decade.

The most drastic pessimists suggested we were seeing a governmental version of the 2008 meltdown of financial institutions, and that Greece represents Bear Stearns, the first investment house to implode in March 2008, which in the fall was followed by Lehman Brothers, AIG and the rest. We believe these anxieties, though understandable, are overdone and that the EU will find a way to put a tourniquet on its most leveraged members. Lastly, we can't ignore that since March the market has been on a tear, and might finally need a pause.

Naturally our international fund, **Dodge & Cox International Fund**, got hit, down 9.4%, but the worst were natural resource stocks, which got it from both the U.S. dollar's robust upswing against the Euro and other currencies as investors fled to U.S. government bonds, which continue to be viewed as a safe harbor (Wrong!) and concerns that if Beijing succeeds in slowing its economy, demand for iron, coal, oil, agricultural products and everything else will slacken. **Anglo-American**, the mining holding company that has ties to Chinese demand, dropped 22.7%, and **Leucadia**, whose passive ownership in mining companies, particularly an Australian miner whose future is closely tied to China, dropped 14.6%. **Transocean**, the ultra deepwater driller, dropped 9.7%, **Fidelity Select Natural Gas Fund** lost 14%, **Agrium**, the fertilizer manufacturer, is down 14.1% and **USAA Precious Metals & Minerals Fund** 14.3%. **Plum Creek Timber** dropped 6.7%.

Broadly speaking, healthcare and other defensive sectors held up better. **Johnson & Johnson**

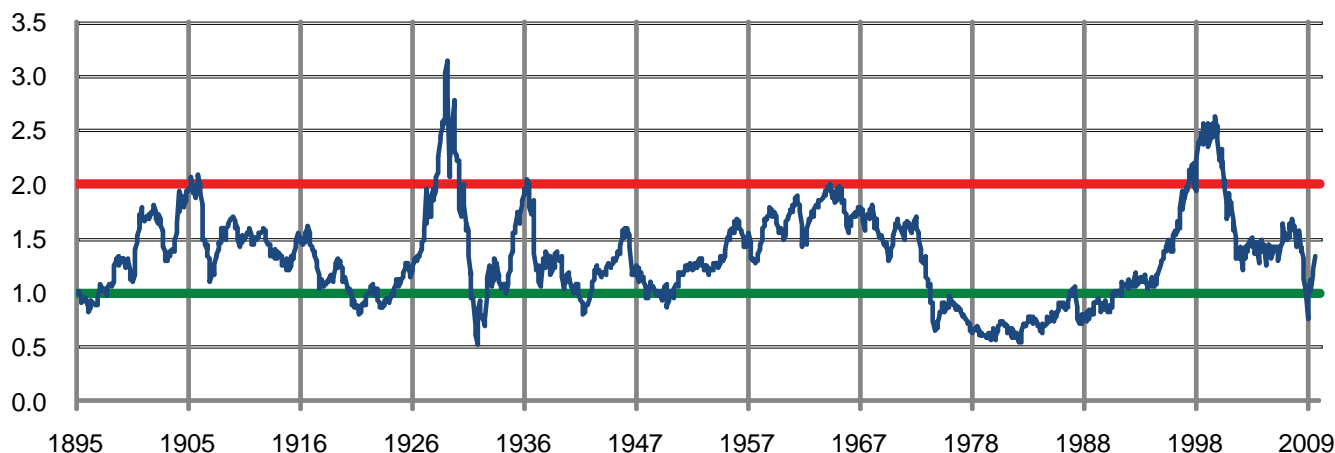
dropped 2.5% (which last month qualifies as better"), though it got a double dose of bad news in mid-January when first it announced a recall of OTC drugs (Tylenol, Benadryl, Motrin and St. Joseph's Aspirin) after concluding that the "bad smell" consumers reported was widespread enough to justify such action. The Justice Department filed a suit against JNJ for inducing Omnicare, which provides drugs and other services to care facilities, to promote its products. When JNJ announced results for the quarter, they were better than expected and guidance was solid. Also, on the upside, JNJ reached a very large settlement with **Boston Scientific** to settle patent disputes involving stents. Unfortunately for us, relatively speaking what is good news for JNJ is really bad news for the smaller **Boston Scientific** that has slid in response to the stent decision. There is no way to sugar coat so big a hit to Boston Scientific's balance sheet. It hurts. But the damage is done, and we think that Boston's stents—apparently thanks in part to JNJ's patents—will continue to have a dominant market share. We're still positive about Boston's future. BSX is down 9.1%. The coming conference call should be interesting.

UnitedHealth fell less than 1%. **Hambrecht & Quist Life Sciences Fund** is off 3.4%, though **Stryker** gave back its gains, and is down 7.8%.

Technology stocks, which led the market up in 2009, have been doing the same to the downside. **Microsoft** reported excellent numbers, but is down 8.6%. **Symantec** also came in with better than expected results, but was pessimistic about coming quarters' prospects, citing the stronger dollar. On the day, SYMC dropped 6.5% and has traded around that level. **Xerox** dropped 1.7%.

We've had a split since the last letter in our two REIT positions. **CGM Realty Fund** is off 10.5%, while **HRPT Properties Trust** was able to hold on to a 1.5% gain. Over the last few weeks, REITs have been weak, which makes HRP an exception. We have no news to explain the divergence.

Which other positions were able to avoid getting hit this month? **Mattel**, the toy maker, announced very strong results with even Barbi showing some luster. Projections were also positive. Since the January letter, the shares are up 1.3%. **Liberty Global**, which is the largest cable operator outside the U.S., sold a couple of assets for hefty profits, and is up 4.1%. John Malone, who is the brain behind all of the Liberty operations, loves nothing more than engineering complex deals, and Liberty Global offers him a new arena. **SA**



The Risk Indicator measures the overall risk in the stock market by plotting the ratio of stock prices to home prices. See *The Science of Making Money in Turbulent Stock Markets* for a full explanation of the Risk Indicator and the Diffusion Indexes. Median home prices have been flat for the last ten months, so the risk indicator is primarily a reflection of stock prices. The latest reading is 1.29. This reading reveals that stocks are still below their average relative to house prices, and present a good value. February's reading of 0.79 likely marked the low for this cycle as well as the beginning of Supercycle 6.

The SoundAdvice Diffusion Indexes

The Diffusion Index of Leading Indicators gives “Aggressive” signals when all four of its individual leading economic indicators drop below their respective levels

of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each “Aggressive” signal, the S&P 500 produces an annual return of 19.3 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.

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		

As far back as February and March we were projecting that our Diffusion Index of leading indicators would hit zero in March, 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. See *The Science of Making Money in Turbulent Markets* (which you received with your subscription) for a history of Supercycles. You will also receive an updated copy when you renew your subscription.

The Diffusion Index of Lagging Indicators gives “Caution” signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. Our next signal will come from this Index. The Commerce Department has not released the underlying indicators at this writing. This Diffusion Index currently stands at 33 percent.

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