

## The Present Value of Stocks



In the fall of 1965, 18-year-old folk singer Arlo Guthrie made his trip from Queens NY to Great Barrington MA to spend Thanksgiving with his friend Alice as she was starting her restaurant. That visit inspired the lyrics for his song *Alice's Restaurant*, "where you can get anything you want."

One of the things that Arlo should have wanted in 1965 was 100 shares of McDonald's, because its IPO was earlier that year. If Arlo had invested in 100 shares of MCD for \$2,200, he would have 74,360 shares today, worth more than \$8.5 million.

I remember loving special trips to McDonald's as a teenager. Knowing then what I know now would have been nice.

Knowing that oil was going to crash 18 months ago would have been nice too. I would have waited until now to invest in energy (with the exception of Valero).

Even with its energy stocks, the *Sound Advice* Portfolio is up so far this year, by 2.9 percent, as compared to 1.0 percent from the S&P 500. We have an average profit of 53 percent, based on the prices at which each position was recommended.

-- Best regards,

-- Gray Emerson Cardiff, Editor

Since our last issue, the Federal Reserve's minutes from the October 27-28 meeting were released and revealed that the majority of the Federal Open Market Committee (FOMC) members felt that the time would be right by the December meeting to start normalizing interest rates. Most also saw the diminishing downside risks from global turbulence.

Unless we see some surprisingly weak economic data between now and the Federal Reserve's December 16-17 meeting, it is likely we will see the first interest rate hike since they were set at zero to bail out the economy after the 2008-09 meltdown. Although the Federal Reserve is promising that the rise will be gradual, the liftoff to normalizing interest rates has profound implications for stocks and bonds. That is because the "present value" of the stock market will change.

If offered a choice between \$100 today or in one year, a rational person will choose \$100 today. That is because today's \$100 will have a higher future value because it can earn interest in the meantime, and be worth more than \$100 in one year. To look at it the other way, the \$100 offered to you in one year is worth less to you by the amount of the interest that could be earned over the year. That lesser amount is the "present value." The higher interest rates are, the lower today's present value will be.

This is one reason rising interest rates have an adverse impact on stock prices. For example, let's say we have a stock with annual quarterly earnings of 50 cents per share, or \$2.00 annually. At today's average price/earnings ratio of 19, the price of the stock would be \$38. Assuming no future earnings growth for the moment, over the next 10 years, these earnings will amount to \$20.00. At today's zero interest rates, future earnings are worth the same as they are today, so the present value will still be \$20.00, or \$2.00 per year on average. However, if we raise interest rates above zero, the future earnings are not worth as much.

As part of the Federal Reserve's economic projections, each member of the FOMC makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot", and medians are taken to formulate the Federal Reserve's official prediction.

The Federal Reserve's most recent Dot Plot predicts the Federal funds rate will rise 3.375 percent in a few years. At that interest rate, the present value of the earnings in our example would be reduced from \$20.00 to \$16.91, or \$1.69 annually on average. At 19 times the present valued annual earnings, the stock price is now \$32.14. This is a reduction of 15.4 percent, based solely on the increase in interest rates.

So far in our example, we assume no growth in earnings for future years. The earnings of most stocks, however, grow over time and are usually assumed to do so. Let's continue our example, but project earnings to grow at an annual rate of, say, 7 percent. Earnings will add up to \$28.62 over the next ten years. At zero interest rates, present value is the same, still \$28.62, or \$2.86 per year. At 19 times these average annual earnings, the stock price would be \$54.37.

However, at interest rates of 3.375 percent, the present value of these earnings becomes \$23.47, for an annual average of \$2.35. At 19 times earnings, the stock price becomes \$45.10, which is a reduction of 17 percent, and slightly worse

than the 15.4 reduction without a growth assumption. Accordingly, the impact of raising interest rates is somewhat more negative for growth stocks.

The impact gets worse when the adverse effect of higher interest rates on growth rates is considered. For most businesses, higher interest rates means higher costs which also means lower earnings. If the earnings growth assumption in our example were shaved from 7 percent to, say, 5 percent, the present value of the earnings becomes \$21.47, or \$2.15 annually. At 19 times these earnings, the price of the stock drops to \$40.80 -- a 25 percent reduction.

If the earnings growth is reduced to 3 percent, the stock price reduction becomes 31.9 percent. With no growth, the reduction becomes 40.9 percent.

By applying this principle to all stocks, the present value of the entire stock market will be reduced by rising interest rates. This downward pressure comes after a long rise in stocks, at a time when the stock market is dangerously high, based on the 1.3 ratio of the total capitalization of the stock market (stock prices of all publicly traded companies multiplied by their respective amounts of shares outstanding) to the gross domestic product (GDP) of the US. This ratio rose above 1.2 in the late 1990s prior to the 2000-02 bear market that took stocks down nearly 50 percent. It also rose above 1.1 just prior to the 2008-09 bear market which took stocks down nearly 50 percent again.

In our June 29, 2015, issue, we announced that the *Sound Advice* Diffusion Index of Lagging Indicators (page 11) rose to 100 percent, issuing a caution signal. Subsequent readings have been 100 percent every month since then, including the latest one announced in mid-November (for October). This makes seven 100 percent readings in a row. (Just one would be sufficient for a caution signal).

Before the August decline in the market, we pointed out the negative divergence in the breadth of the market (substantial deterioration in the advance-decline line of all NYSE stocks versus the S&P 500). Since then, however, there has not been significant divergence, either positive or negative.

From this perspective, we can conclude that stocks in general are precariously high, particularly with rising interest rates on the horizon and our Diffusion Index of Lagging Indicators issuing a string of caution signals. At times like this, it is vital to confine portfolio selections to special situations and focus on value. With this in mind, here are updates on our portfolio selections.

### Hedging the Portfolio

The plethora of warning signs has prompted the addition of an ETF that will benefit from a declining stock market.

The [ProShares UltraShort S&P 500 \(SDS\)](#) is a reverse ETF that is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0

percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

As with any reverse ETF, SDS will erode slightly over a long period of time because it will decline slightly more than it will increase with an equal movement in the S&P 500. The erosion factor is nominal in comparison to normal market movements, but it can add up over an extended period. The 2:1 leverage amplifies this erosion factor as well.

Accordingly, SDS is not a long-term holding proposition. However, for the near term, it will serve as a counter-balance to the rest of our portfolio in a general market correction. The 2:1 leverage factor means that it will better serve this purpose without making a large investment. It is also in the aggressive segment of our portfolio. See the table on page 9.

### Rising Interest Rates

We are also recommending three ETFs designed to benefit from the inevitable rise in long-term Treasury bond yields. We have dubbed these ETFs as “No-Brainers” because interest rates and bond yields always rise during an economic recovery. In the current cycle, we are simply looking for interest rates to normalize.

These ETFs differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

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

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

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

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds. The prices of these ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

As we have pointed out in the past, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields. This erosion factor is nominal in comparison to the price swings caused by a change in bond yields, but it can become significant over an extended period of time.

We can project the movements of these ETFs based on any given scenario. The most recent Dot Plot taken at the Federal Reserve's September meeting predicts that the Federal funds

rate will be 1.375% by the end of 2016, 2.375% by the end of 2017, and 3.375% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with the latest Dot Plot predictions of the Federal Funds rate, here is what would happen to each ETF:

TMV would rise to \$56 by the end of 2016, to \$88 by the end of 2017, and to \$131 by the end of 2018.

TBT would rise to \$70 by the end of 2016, to \$94 by the end of 2017, and to \$123 by the end of 2018.

TBF would rise to \$31 by the end of 2016, to \$36 by the end of 2017 and to \$41 by the end of 2018.

Whether or not the Federal Reserve actually raises interest rates in the December meeting is not critical to the longer term performance of these ETFs. As long as the targets in 2016 and beyond were met, the projected prices of these ETFs would remain the same.

## Energy Selections

Our primary thesis remains the same: The industry has been decimated by the oil glut, and “impaired” the value of oil and gas properties. Impairment write-downs must be taken by a company when the value of assets falls below the value on its books. Although impairment write-downs are accounting entries, and not real money, they reduce the value of the assets that can be used as collateral for loans to finance drilling. Valuations must be based on a 12-month moving average (the average of the most recent 12 months) of oil and gas prices. When oil and gas prices stop falling, impairments will also stop. All US oil-and-gas producers have written down the value of their drilling fields by more in 2015 than in any full year in history, even more than the previous record set in the 2008 melt-down.

The price of oil has fallen below the cost to drill, and new drilling is certain to continue declining. It is only a matter of time until the glut will disappear.

We also know that US production will continue to fall off because of the nature of fracked oil wells. Production drops 70 percent during the first year from the typical fracked well. This requires a substantial amount of new wells to be added to maintain overall production levels. We know that is not happening because the domestic drilling rig count has plunged 50 percent since October 2014.

US production has been tapering off since the peak in early June. As of the week ending 11/25/2015 (the latest week reported), US production is down by 445 thousand barrels per day. There were 488 million barrels of oil in US storage tanks. To put this glut in perspective, the oil in US

storage tanks amounts to only 68 days of oil imports into the US.

As production continues to decline and becomes more pronounced, draws from storage tanks are certain to be substantial. That means the oil glut will disappear, and the price of oil will recover.

In the last week of November, Saudi Arabia pledged to work toward oil price stability, and oil prices responded positively on the announcement. OPEC's next meeting on production targets is on December 4. A reduction in production targets would be bullish.

With oil and gas prices bouncing around their lows in recent months, it appears that we are near the bottom of the price crash. As it has in past cycles, a recovery in oil and gas prices from the most recent crash is bound to translate into stellar profits from carefully chosen oil and gas stocks. Here are updates to our energy portfolio, in alphabetical order.

**Chevron (CVX)** is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling, to transporting and refining, and even to retail sales at its gas stations. Profits vary from these various stages of production, depending on price demand for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. When oil prices are low, profit margins expand from refining, but not nearly enough to offset declines in drilling profits. This quarter is a case in point. While drilling (upstream) profits were poor, profits from refining (downstream) were higher, which helped balance overall earnings.

The company's currently depressed earnings do not quite cover the dividend. However, management has pronounced the annual dividend of \$4.28 per share as “sacrosanct.” As such, the current yield of more than 5.5 percent puts a floor under the stock price while we wait for a recovery in oil prices.

**Chesapeake Energy (CHK)** has taken a beating from the crash in oil and gas prices. Since our last issue, Chesapeake (CHK) reported a loss of 5 cents per share for the third quarter, along with an impairment loss of nearly \$7.00 per share.

Morningstar's (<http://www.morningstar.com>) fair market value valuation of CHK was \$25 during the second quarter. After the second quarter results were reported, and as oil and gas prices continued declining, the valuation was lowered to \$19 per share. After reviewing the third quarter results and financials, and updating oil and gas futures prices, Morningstar's fair market value valuation remained unchanged as \$19 a share.

In order to survive, Chesapeake has recently cut 15 percent

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of its workforce and is reducing its 2016 capital expenditure target by another \$100 million to \$3.4 billion. In November, CEO Doug Lawler told investors on a conference call: “We intend to meaningfully reduce our capital spending next year. We are not designing this business around increasing prices.”

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly.

The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$42 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to \$2.23 for one million BTUs, 5.8 million BTUs will cost \$12.93 (5.8x\$2.25). So the same amount of energy is available for 31 cents on the dollar, if it is in the form of natural gas rather than oil.

An updated chart is below, showing the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together, but remain substantially apart. This difference still translates into an expanding natural gas industry.

**ICON Energy Fund Class S (ICENX)** is also a diversified way to participate in the recovery with a basket of

substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sectors to capture value, rather than simply depending on rising oil prices. For example, the profit margins expand on pipelines when the price of oil is low, because the cost and price of storage and transportation have little to do with the price of oil.

In the past, this fund has achieved growth even during periods of declining and volatile energy prices. The fiscal year ending September 30 was not one of them. The fund under-performed the S&P Composite 1500 Energy Index due to its heavy weighting of oil and gas exploration and production companies. The fund was also underweighted in the integrated oil and gas industry. The fund over-weighted the oil & gas refining & marketing industry but not enough to counterbalance.

Over the course of the upcoming year, management is looking for signs of stabilization in forward looking earnings, and will reposition the Fund as valuations dictate. For example, the recent selloff of the oil and gas storage & transportation industry has provided an entry point to overweight in this industry.

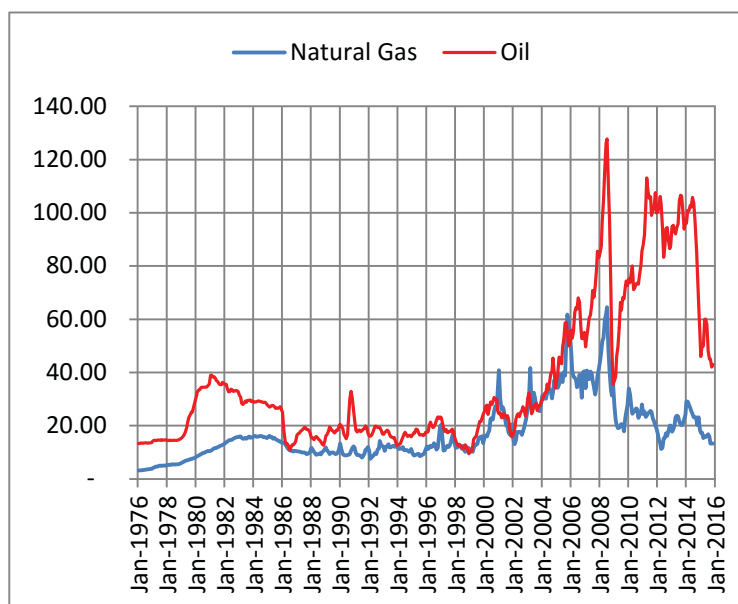
Although this fund may under-perform energy indexes at times, it is a diversified energy fund investing in all sectors of the industry. This fund is a good way to capture today’s values and profit from the recovery and changing landscape on a diversified basis.

**Transocean (RIG)** makes deep-water drilling rigs and leases them to major oil producers around the world. RIG has been sharply impacted because the utilization of its rigs has fallen along with the drop in oil prices. As we have previously reported, management is proposing to eliminate the next 2 dividends, one for December 2015 and one for March 2016 in order to maintain as much flexibility as possible as reflected in a strong, liquid balance sheet.

We continue to recommend RIG because its prospects of survival are being improved, along with the prospects of longer-term growth from here. Third quarter earnings came in at 87 cents per share, bringing the year’s total to \$3.48. This puts the current price/earnings ratio close to 4. The company still has a \$17 billion backlog with \$5 billion in liquidity. Although overall utility rates have dropped, the company’s highest revenue rigs in the Gulf of Mexico also have the highest utility rates. The US still imports close to 7 million barrels per day. Deep water drilling is still a necessary source for the US and the world’s oil needs, especially as US fracking drops off. Long-term profits from RIG should be stellar from here.

**Valero Energy (VLO)** is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland, under the brands Valero, Beacon, Ultramar, Shamrock, and Texaco. Valero is one of the few energy companies that can benefit from lower oil prices because refining margins generally expand during such times. This is evidenced by the 30 percent rise in refining margins during the third quarter, to \$14.38 per barrel from \$11.81 one

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



year ago.

Most US refineries are not set up to handle the light, sweet, crude oil that is coming from fracking US shale. Valero's refineries are notable exceptions because they are the most flexible refineries, allowing Valero to capture the highest margins among its competitors. Valero's refineries are also well positioned geographically, even for accessing the low-cost Maya crude from Mexico, heavy sour oil that Valero buys for an even larger discount than from glutted US oil.

Although VLO has risen in recent months, it remains an astonishing value. Earnings are expected to be in the vicinity of \$8.00 per share in the year ahead, which puts VLO's forward price/earnings ratio (P/E) close to 9. -- a very low P/E for any stock and a deep discount from the overall market.

VLO also just hiked the quarterly dividend by 25 percent to 50 cents per share, which brings the current yield slightly under 3 percent.

### Real Estate Selections

Low interest rates for so many years have pushed down real estate capitalization (cap) rates (the yield before debt payments are considered) to historically low levels. As a result, commercial real estate prices are historically high, and the average real estate investment trust (REIT) does not present a particularly good value.

In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising interest rates. However, this benefit is most likely to translate into profits only on real estate stocks offering an extraordinary value now.

**Hersha Hospitality (HT)** is selling at a discount to its hotel assets because most of its major properties have been undergoing renovations and not producing their full income potential. Income is rising from new acquisitions and completed renovations, as evidenced by the year-over-year 17.7 percent increase in third quarter funds from operations (FFO), following the second quarter's increase of 13.9 percent.

Revenue per available room (RevPAR) is growing in all geographical areas, from Manhattan to Boston, Miami, and California. We estimate the net asset value (NAV) of Hersha's hotel properties is at least \$29.22, based on the net operating income of the most recent four quarters. We expect the NAV of HT to increase as renovations and new acquisitions add to revenue.

**Retail Opportunities Investment Corp (ROIC)** began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. As new properties are added, along with tenant upgrades, funds from operations (FFO) are bound to

continue to rise.

This trend continued during the most recent third quarter. ROIC acquired four grocery-anchored shopping centers and contracted for two more, increasing the total for the year to \$310 million and achieving the original 2015 goal. The quarter ended with a strong 18.2 percent increase in funds from operations (FFO) and occupancy of 97.1 percent. ROIC also pays an attractive dividend which lowers its risk profile.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is replete with stellar values substantially below NAV with strong growth prospects.

Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams to come up with their estimates of intrinsic value. An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

TVRVX has a number of distinguishing characteristics. This is a global real estate fund. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management also looks for opportunities in different points of a real estate company's capital structure by investing in senior debt in addition to a company's equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities in distressed times.

Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

### Medically-Related Selections

This sector is defensive because medical needs persist regardless of financial conditions. The world's inexorable demographic aging trends and the commensurate increase in medical care needs translate into strong growth prospects for this industry.

**Boston Scientific (BSX)** produces medical products that are well suited for an aging population. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for

three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX has more than 900 US patents.

In November, BSX announced that the first implants occurred in Europe of its latest *Watchman FLX Left Atrial Appendage Closure Device*, which is implanted to prevent atrial fibrillation. After receiving Europe's regulatory approval, BSX is rolling out the product to clinicians.

**Pfizer (PFE)** has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. The company is well positioned with several break-through drugs and treatments.

In the last week of November, PFE and Botox maker Allergan agreed to merge, creating the world's biggest pharmaceutical company in terms of sales. PFE would domicile in Ireland which will result in lower tax rates. Allergan stockholders will receive 11.3 PFE shares for each Allergan share. Although Allergan is based in Ireland, it has a sizable operation in Irvine, California.

Pfizer claims that it makes all of its profits overseas, with nearly \$17 billion earned overseas and close to \$5 billion of losses in America. US companies don't have to pay US taxes on foreign earnings until it is brought into the country. Pfizer still books the unpaid tax as an expense because it would ultimately have to pay it as long as it is a US company. Last year, that amounted to \$2.2 billion. However, these taxes will not be owed once Pfizer is an Irish company. That will be a boost to earnings.

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

Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions. The most significant recent acquisition was MAKO Surgical, which recently received FDA clearance for its knee and hip applications, enhancing SYK's robotic reconstructive solutions. Other recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

**Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL)** is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last

one, five, and ten year periods.

Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

## Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. This is especially true during a recovering economy. Small-cap stocks perform better than large-cap stocks because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually quite profitable. They also tend to be domestic companies without substantial overseas exposure, and therefore are not buffeted by the currency fluctuations that currently haunt larger companies. Here more than ever, attention to value is paramount.

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

## Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

**Agrium (AGU)** is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products, aimed at increasing the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while population and per-capita income increases. This translates into a need for greater crop output per acre through the use of AGU's products.

Close to one-half of AGU's earnings come from its retail stores offering farm products, and the other half comes from its wholesale sales of fertilizers, mostly nitrogen-based but also from potash and phosphates. This diversification protects AGU from swings in the markets and brings steady sources of growing free cash flow for future growth.

In November, AGU reported earnings of 72 cents per share, ahead of expectations and 11 percent higher than one year ago. Better cost controls and expanding margins were behind the earnings growth.

AGU is trading at close to 12 times next year's earnings estimate of \$7.25 per share. This is a good value with a growing dividend.

Sharing our opinion is the company's CEO, Charles Magro, who purchased over 7,000 shares in 2015.

Jeff Ubben, founder, CEO and CIO of ValueAct Holding, which concentrates on acquiring significant ownership stakes in fundamentally undervalued companies, recently increased his AGU holding by 25 percent to 10 million shares.

**Disney (DIS)** reported earnings of \$1.20 per share in November, which was higher than the expected \$1.14 per share, and 35 percent higher than one year ago. As we reported in our November email update, sales revenue was \$13.51 billion, 9 percent higher than one year ago, but a shade lower than the expectation of \$13.57 billion.

As much attention as its endearing movies and characters attract, half of Disney's earnings come from its cable networks -- the Disney Channel, ABC, the ABC Family Network, and the largest by far, ESPN and its sister networks.

Of particular interest was the revenue from the cable network segment because last quarter's earnings disappointment was caused by a decline in ESPN revenues. However, this quarter, revenue from the cable network segment increased by 12 percent, to \$4.25 billion, due to higher affiliate fees in addition to stronger advertising revenue at the ESPN and ABC networks.

Disney's widely anticipated *Star Wars: The Force Awakens* movie opens on December 18. The first trailer was launched during Disney-owned ESPN's Monday Night Football broadcast in mid-October. As we noted in our mid-October email update, the overwhelming demand for tickets knocked out several movie ticket websites, including Fandango, for a brief period. The initial demand indicates that this will indeed be one of the largest openings for a movie of all time, if not the largest. Most published estimates for the worldwide box office take are the \$2 – 2.5B range, putting it in second place behind 2009's *Avatar* for the highest grossing movie in history. However, many predict it will easily surpass both. It's already set to smash other records, opening in more than 4,500 theaters, the most ever, and has already secured the exclusive use of every IMAX screen in the US for the first month after release. We will be watching the box office receipts with interest.

**Ford (F)** reported strong third quarter earnings in late October of 45 cents per share, up 89 percent from one year ago. As we have been pointing in previous issues, earnings have been depressed because of down time and preparation for 24 new or refreshed vehicles, including Ford's new all-aluminum F-150 truck which weighs 700 pounds less than last year's model and gets close to 30 miles to the gallon. The F-150 is Ford's best-selling vehicle in the US and the company's most profitable product, even as volume has been held back by production capacity.

On the cost side, Ford is reducing the number of platforms it uses to produce its models, from 27 in 2007

to 9 by 2016, which will save billions of dollars through economies of scale, and give Ford more agility to adapt to changes in demand.

In late November, United Auto workers (UAW) negotiations finally concluded with Ford workers narrowly approving a new four-year agreement. This means that Ford (along with GM, and Fiat Chrysler) can look forward to four years of labor peace, which will provide a more secure environment for making the large investments needed to improve Ford's prosperity.

Earnings are expected to be \$1.93 next year, putting the forward price/earnings (P/E) ratio below 7. This P/E ratio is far too low for a stock offering a solid dividend along with growth prospects.

**Freeport-McMoRan Copper & Gold (FCX)** is the world's largest copper producer. It also has significant oil and gas assets which it acquired at the top of the market in 2013. This was particularly unfortunate because FCX took on a large amount of debt to make the acquisition. The added leverage, along with sinking prices on these commodities, has decimated FCX.

The only good news recently is that activist investor Carl Icahn has invested in a stake of 88 million shares of FCX, which makes him its largest shareholder. He says, "When they are throwing stocks like this on the dump heap, it is time to buy them."

It is likely that Mr. Icahn is not just simply making an investment in a cheap stock. He usually has a plan in mind aimed at fixing the current problems, and coercing management into adapting his ideas.

Icahn usually starts by cutting expenses and reducing debt, which the company says it is doing.

Chief Executive Richard Adkerson says, "We're prepared to do whatever it takes to keep our operations generating positive cash flows, to protect our liquidity and hold onto these assets for a better day."

The company also says that the primary strategic objective is "significant" reduction of its \$20.7 billion debt, and anticipates improved cash flow in 2016 and 2017 as it winds down project spending and increases production. So far, there has been no indication of how the FCX is going to reduce its debt. Earlier this year, there were discussions of spinning off the oil and gas division. Although it is not a particularly good time, that seems like the most plausible solution. If and when that happens, we will advise on what to do.

Meanwhile, FCX is worth holding for a better day.

**NCR Corp (NCR)** makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

If you own NCR, you may be getting notices about tendering your shares to NCR's Dutch auction. We do not recommend tendering your shares to NCR's Dutch auction.

We discussed our reasoning for our recommendation in our late-November email update. Below is that update for those who may have not have received or noticed it.

When it comes to English phrases containing the word “Dutch”, it is usually not a good thing. That’s because the English and Dutch empires were competing and warring against each other for hundreds of years during the 17th and 18th centuries. It’s because the Dutch were despised during those years by the English, that the majority of English language references have negative connotations.

A Dutch treat (1887) is no treat at all because each person pays. Dutch comfort (1796) is only good because it could have been worse. Dutch defense (1749) happens when a defendant gets off free by deceitfully betraying others. Dutch courage (1826) is courage induced by drinking alcohol. Dutch feast (1785) happens when the host gets drunk before his guest. Dutch gold (1825) is a cheap alloy of metals that looks like gold.

NCR’s Dutch auction will run through December 11, 2015. Stockholders will be allowed to tender shares and name their minimum price, anywhere between \$26.00 and \$29.50. After the tenders are received, NCR will choose at the lowest price within the offer range that enables the purchase of \$1 billion of shares. If you tender your shares at, say \$28, and NCR’s purchase price ends up being \$28.50, you will receive \$28.50. However, if you tendered at \$29, your shares will not be purchased.

The auction seems worthy of its Dutch reference because it gives an advantage to NCR while not really being an open auction.

Most of the funds for NCR’s Dutch auction are being provided by a deal made with Blackstone, whereby Blackstone will purchase \$820 million in convertible preferred stock that is perpetually convertible into NCR common stock at \$30 per share. This gives Blackstone equity in 27.3 million common shares when it rises above \$30. This is a dilution of close to 14 percent. However, the dilution is offset by NCR’s purchase of \$1 billion in NCR stock in the Dutch auction.

While the terms of a Dutch auction are somewhat offensive, the overall transaction should be positive for NCR in the longer run. This is because Blackstone will have an on-going stake in NCR. Blackstone has a successful track record with investments such as this. Blackstone is a savvy private equity and advisory firm, and evidently sees that it can accelerate NCR’s transformation into a software-

driven business, and add significant value to NCR above \$30.

In addition, we have stressed in the pages of *Sound Advice*, that NCR is an undervalued stock, even at \$30. Blackstone obviously agrees.

**Symantec (SYMC)** is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. Nearly all of the Fortune 500 companies are Symantec customers. According to Symantec’s latest annual Internet Security Threat Report, cyber-attacks against large corporations have jumped by 40% this year. If there ever was a more certain growth industry, protection from cyber espionage is it.

The sale of Symantec’s subsidiary Veritas will take place by the end of this year to the Carlyle Group for \$6.3 billion. The sale will transform Symantec into a pure-play security vendor. Approximately \$2.5 billion of the sale proceeds is planned to be returned to shareholders through share buybacks and dividends. The balance is aimed at acquisitions and R&D to booster growth in SYMC’s core businesses of threat protection, information protection, and cybersecurity services.

This new-found focus and capital should launch a new growth phase for SYMC.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets.

TTEK is making a takeover offer to acquire Coffey International for \$77 million. Coffey’s is a good fit and should bolster TTEK’s growth in the next few years. In view of the growth prospects offered by Coffey, the price is a good deal which is made even better with a strong US dollar for an Australian company.

One of Coffey’s strengths is its international development division, which will help TTEK implement the numerous overseas contracts awarded to it in 2015. In addition, Coffey’s Geoservices division can take over TTEK’s low-margin work in this area. Coffey will also give TTEK an entry into Australia to expand its strongest area, water engineering services.

**Xerox (XRX)** is continuing to transform from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenue. These outsourcing arrangements are long term in nature and encompass a wide range of profitable services for larger customers and result in contract renewals of close to 90 percent.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Hersha Hospitality Trust	HT	NYSE	\$ 23.61	4.74%	\$ 28.42	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 18.29	3.28%	\$ 19.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 30.73	1.43%	\$ 34.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	\$ 98.73	3.16%	\$ 110.00	BUY
Disney	DIS	NYSE	\$ 113.47	1.16%	\$ 118.00	BUY
Ford Motor Company	F	NYSE	\$ 14.33	3.49%	\$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 8.18	2.44%	\$ 14.00	BUY
NCR Corp	NCR	NYSE	\$ 27.11	0.00%	\$ 30.00	BUY
Pfizer	PFE	NYSE	\$ 32.77	3.42%	\$ 36.00	BUY
Stryker Corp.	SYK	NYSE	\$ 96.46	1.10%	\$ 105.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 27.79	1.15%	\$ 27.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 22.54	0.00%	\$ 24.00	BUY
Xerox	XRX	NYSE	\$ 10.55	2.37%	\$ 11.00	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 5.27	0.00%	\$ 10.00	BUY
Chevron	CVX	NYSE	\$ 91.32	4.69%	\$ 100.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 24.80	1.33%	\$ 30.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 12.01	0.75%	\$ 14.00	BUY
Transocean	RIG	NYSE	\$ 14.36	0.00%	\$ 19.00	BUY
Valero	VLO	NYSE	\$ 71.86	2.78%	\$ 75.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 18.28	0.00%	\$ 19.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 28.18	0.00%	\$ 34.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 24.76	0.00%	\$ 26.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 44.18	0.00%	\$ 47.00	BUY
S&P 500 ProShares Ultra Short ETF	SDS	NYSE	\$ 19.43	0.00%	\$ 22.00	BUY
Symantec	SYMC	NASDAQ	\$ 19.58	3.06%	\$ 23.00	BUY
Tekla Life Sciences Fund	HQL	NYSE	\$ 25.42	0.00%	\$ 28.00	BUY

**Notes to the table:**

Prices are as of 11/30/2015. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

We have been emphasizing that XRX is very cheap relative to the rest of the market, and a good value. Evidently, Carl Icahn agrees. On November 23, it was announced that he purchased 72 million XRX for \$86.5 million, close to 7 percent of the outstanding shares. XRX jumped 10 percent following the announcement in after-hours trading.

As we know, Icahn doesn't simply invest in under-valued companies. He is an activist. He typically buys undervalued stock in companies where there is something to fix in order to unlock value.

In the case of XRX, Icahn will likely start with upper management who have been comfortably paid despite

poor performance. We have written about past surprising cost over-runs that have impacted earnings, which is an indication of poor planning and execution on the part of executives. The company's employees bring in less sales volume than its competitors, indicating poor incentive structure and management.

Another component of Icahn's approach is to separate business segments to improve management efficiency and focus. He also likes to spin-off non-core assets, and put the capital to better use. Xerox is a candidate for this strategy.

Icahn's XRX purchase and upcoming actions are bound to be positive for both the near term and long term prospects.

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

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

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

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

We can, therefore, label this new tool the SoundAdvice "Risk Indicator," since it will allow us to locate the point at which prices are so high when

compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

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

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$12.3 million in stocks and to \$1.64 million in houses.

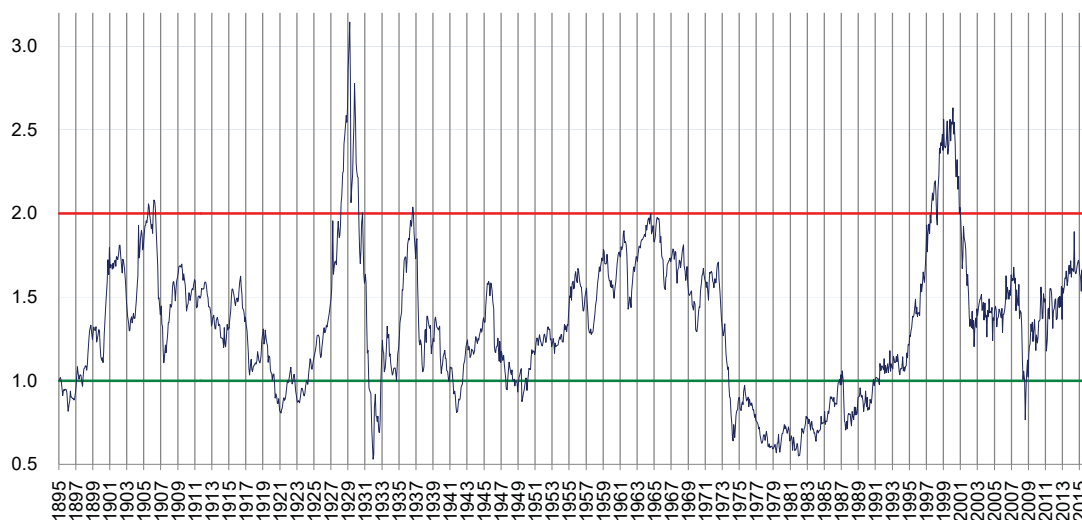
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$488 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

### The SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.6. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

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



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

When the SoundAdvice Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the soft economy is providing an atmosphere for stable or declining interest rates.

This Diffusion Index gave us a zero reading in March, 2015.

The previous zero reading was in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

**However, the March 2015 signal was usurped.**

**The SoundAdvice Diffusion Index of Lagging Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which reveals that the economy is about to put upward pressures on interest rates.

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

This index hit 100% in 2012. Although we operated under the "Caution" signal, we have continued to be bullish about stocks because of the Federal Reserve's expansive monetary policy and its quantitative easing program, which has been distorting the natural business cycle.

**The lagging economic indicators released in June, 2015, (for May) caused the SoundAdvice Diffusion Index of Lagging indicators to hit 100 percent, giving us a new caution signal.**

### Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32 percent. During "Caution" signals, the S&P 500 increased an average of 2.4 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.0%		2.4%

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

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