Gray Cardiff's

SOUND ADVICE

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Last weekend's *Barron's* cover article brought together 10 eminent market strategists to determine "What's Next for Stocks?" *Barron's* characterizes them as bullish, but not entirely.

One expects a 9% retreat in the S&P, but another a 15% increase from where the S&P closed last Friday (1016). The midrange is tepid. As a group they project a 4% gain for the S&P from here. The strategists' likes and dislikes (a total of 65) are typical for an economic expansion that most anticipate. Eight praise technology and seven energy. Six like industrials and five recommend financials. As for dislikes, seven are shunning utilities, six warn against consumer staples and four are steering clear of telecom. None of these sectors has a single friend.

So does it make sense to buy what these wise men uniformly like and avoid what they uniformly distrust?

Not really. There is money to be made in what they consider stagnant industries. Thus, as the long holiday weekend comes to an end, the big news is that Kraft—in the despised consumer staple sector—has kicked off what most likely will be a bidding war for Cadbury, another consumer staple company, offering a 31% premium to where CBY closed on Friday. Meanwhile, telecom deals are brewing, mostly abroad. Indeed, there are many cheap companies in every sector that after the crushing drops in sales and in share prices are trading at very attractive levels. Even if market strategists are focused on growth industries, there will be solid profits for shareholders in companies with consistent sources of profits and cash flow either as acquisitions or as ongoing businesses—like Cadbury.

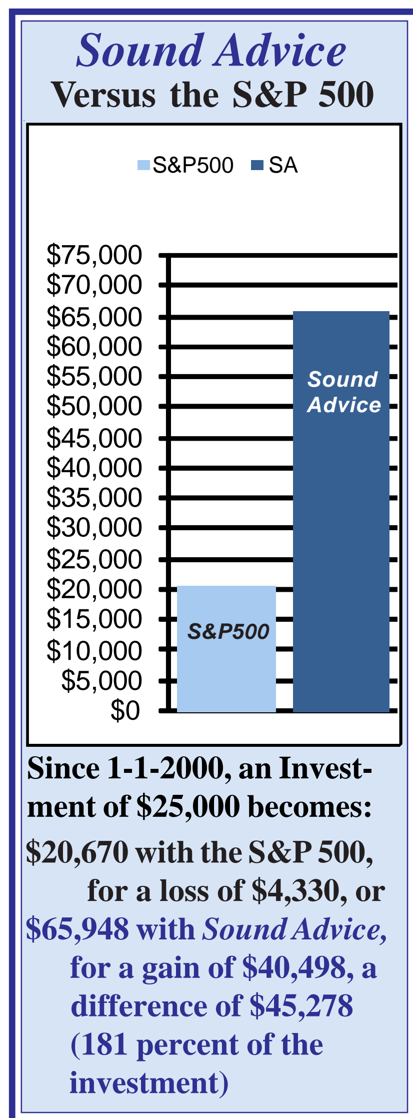
--Gray Emerson Cardiff

Must September-October Bring Back the Bear?

The financial media has run up the warning flags, again. The market is overbought, has gotten ahead of itself, is due at best for a correction and at worst for a resumption of the most vicious bear market since the 1930s. Insiders are selling. Short positions are rising. With unemployment approaching 10%, consumers have zipped their purses and won't play their traditional role. Another wave of mortgage foreclosures is about to swamp the country, and this time the biggest damage will come from commercial real estate. Smart money has cleared out to wait for a more opportune entry point. After the first three trading days of September had taken the S&P down all of 2.5%, the noise got louder but was then muffled by two up days.

Perhaps the pessimists this time are right. But when opinion congregates so uniformly around what happens next, there is a significant probability that the so-called "wisdom of the crowd," will fail.

Last month's cover essay, "We Stayed in May," confessed the obvious: *Sound Advice* has ignored, to our profit, the Wall Street wisdom that counsels getting out of equities between the start of May and Halloween and jumping back in for the next six months. Admittedly, we still have almost two more months—potentially the two most treacherous months— till we can close the book on the May-October stretch. Nonetheless, since we violated that "strategy" this year, our portfolio is up 29%, while the standard benchmarks are up 15%.. Still, there are plenty of arguments to suggest



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it's dangerous to thumb your nose at what so many believe. *The Stock Trader's Almanac*, a delightfully thought-provoking annual published by the Hirsch family, has repackaged the Go-Away-in-May/Buy in November idea by promoting the "Best Six Month's" strategy. The paper results are eye-popping.

But how rare is for the market to contradict that model? In 2007, for instance, you would have made money when you were supposed to lose it during the May-November period, and lost it when you were supposed to make it between November and the following May. And it partially happened again this past year: the supposedly profitable November 2008–May 2009 stretch generated losses, though worse damage occurred between May 2008 and Halloween, and the worst of that in September and October. Could there be something more than how the stars align during each of these six month intervals to explain the market's apparent vulnerability between May and November?

Just as May 2009 was about to start, Bob Pisani, the calmest of the CNBC market watchers, looking ahead to the go-away period and back at the ongoing March-April rally, wondered whether events could overrule the go-away pattern. He noted that <u>the May-November period skewed toward losses only during bear markets</u>. During bull markets, there was a slight bias but hardly the sure thing the Hirsch strategy predicts. Indeed, Pisani threw in one factoid that tantalizes us: "Jeff Hirsch noted to me that so far [in the 2008-2009 period] this best six months buy (buy Nov. 1, sell April 30) is down 12% since Oct. 31. We also had a negative best six months (Oct 07-April 08) the year before that. The last time that happened was 1973-74."

Remember 1973-1974? Between January 1973 and October 1974, the worst post-war bear market, the S&P dropped 58 points or 48%. It's no surprise that the Best Six Months/ Go Away In May failed to work. The tantalizing part, however, is that those two terrible years gave way to the greatest bull market of the last hundred years. It essentially continued till 2000, when it faltered, recovered two years later and ran till October 2007. Then came the worst bear market since the 1930s. From the top in October 2007 to the March 9th bottom, the S&P tumbled 889 points or 57%.

Are we saying that almost two years of terrible bear market conditions guarantee the dawn of a new bull market? Hardly. We're not that impressed with ourselves. But ut our long-term indicators, which rely mostly on the economy and not market action, now predict a long period of rising stock prices. <u>The last time our Diffusion Index of Leading Indicators and our Risk Indicator aligned this way was in May 1974, the start of what we term Supercycle Five. By our indicators, we are now at the start of Supercycle Six</u>.

FALLING LEAVES, FALLING PRICES?

After the go-away in May warning flags succeeded only in keeping believers on the beach as the March rally rolled on, this time the financial media are hammering the message that now we are in the truly perilous part of the May-October period: September and October. <u>Everybody</u> knows that every fall fortunes are lost as the market crashes. According to the Hirsch *Almanac,* for the last 60 years September has been the roughest month for stocks, and if September is the worst month, October includes the worst days.

Of the 10 biggest daily drops in the S&P beginning in 1950, one occurred in September and five in October. If going away in May makes sense to some, climbing into the tornado shelter for September and October should be even more compelling.

September 2002, part of a five-year run of September market declines (1999-2003), was the worst (-11%) in the post-war period. Last September, studded with catastrophic financial news (Lehman Brothers, AIG, Merrill Lynch, Countrywide, Wachovia, Fannie and Freddie…), produced the second worst September for the S&P (-8.9%). In terms of gut-wrenching terror October, forever linked to 1929's Black Thursday, Friday, Monday and Tuesday, and 1987's Black Monday (10/19), is the gold standard. And yet, the Hirschs note that on average Octobers have produced nearly a 1% gain in the S&P 500. For that matter, had you bought the S&P 500 at Friday's close <u>before 1987's Black Monday</u>, and absorbed that day's full pain, you'd have more than tripled your investment over 22 years.

Sound Advice remains bullish. Global economies are beginning their recoveries, fundamentals remain attractive for stocks, and though we have serious concerns about the inflationary impact of the mammoth stimulus and bank rescue measures, we believe equities are at the start of a protracted and very profitable bull market. Trying to time exposure to the market on the basis of old saws like the May/November model, or scurrying for cover as September starts, we believe, is counterproductive to long-term profits, and isn't that what this is all about? ***SA***

Replacing Funds

We are replacing the two Icon sector fund (finance and energy). After watching them in action over a bull and a bear market, we've concluded that their underlying strategy, though presented as value oriented, have a momentumish quality that works well in rising markets but is not productive in either falling or sideways markets. Icon's quantitative approach requires investing in subsectors that are outperforming within an industry. For example, the **Icon Energy Fund** would respond to superior relative performance from the integrated energy companies by loading up on the Exxons, Chevrons and British Petroleums, but then, were energy services companies to show better relative performance, shift over to companies like Schlumberger, Diamond Shamrock and Transocean. Though this might be profitable in a rising market, it works less well when an entire sector or the entire market is in a downward spiral. Though Icon asserts that sector outperformance is durable and can last for years, when you are shifting between subsectors in a falling market, you are just moving from one deck chair to another on the Titanic plus you are paying for the privilege. And when a market abruptly does shift from bear to bull, as finance and energy have done since March, the results can be especially galling. Consider the **Icon Financial Fund**'s portfolio shifts between March 31, 2008 and March 21, 2009.

In 2008, the largest sector was "Diversified Banks" (14.8%) and "Regional Banks" (14.4%). Twelve months later, one of the ugliest in market history, particularly for financial services stocks, thanks to Icons' sector shifting, these sectors had almost disappeared from the portfolio, reduced respectively by 83.1% and 82.2%. The new dominant sectors were Investment Banking (21.6%) and Property & Casualty Insurance (13.6%).

When the market did turn finally in early March and financial stocks rocketed, the banks were particularly strong. For example, Wells Fargo, which had been ICFSX's largest investment ($13.2 million) in March 2008, had been liquidated entirely. However, between March 31st and today, WFC is up 88%, just 8% below where it had traded in at the end of March 2008. For that matter, of Icon's other nine largest positions in March 2008 all but one (Bank of New York, slashed by 97%) were eliminated. If we look at the top 10 positions ICFSX held in March 2009, on average they are up 24.6%. The top 10 positions from March 2008, which the fund purged? For the sam period, they are up 55.5%.

DAVIS FINANCIAL FUND

Perhaps the first question we should confront is why hold a financial services fund at all? The FDIC continues to hand troubled banks over to stronger competitors. Credit card delinquencies continue at high rates. Should the housing market not change, we can expect another wave of home foreclosures. Trash derivative instruments remain on the books of many financial institutions. Commercial property owners, especially of hotels, who overleveraged their properties are turning in the keys to their lenders. Unemployment remains high. Consumers have turned from spenders to savers. The U.S. and most other major economies remain in recession. In the coming years, we also cannot expect a return to the lush profits banks and other financial intermediaries accumulated, since the grotesque use of borrowed funds to magnify returns no longer will be tolerated, though eventually financiers will find a way to recreate that "advantage."

Finally, given the pain the average fund's shareholders have endured (the average fund's annualized 3-year performance is minus 14.5% and 5-year minus 5.6%), most investors might want to stay as far away as possible from anything that reminds them of how expensive the collapse has been. However, financials have led the market recovery with the average financial fund up 17% year to date and should rise along with a recovering economy.

That gain has tempered the sky-is-falling mentality that prevailed in late winer. Ken Feinberg, the lead manager of our recommendation, the **Davis Financial Fund** (**DFIBX**), observed in his 2008 annual report composed before the financials began to levitate in March: " One of the few positives today is that the overwhelming consensus of opinion is exceedingly negative." Indeed, he goes on to quote the Buffett line we favored in the August issue: "Be fearful when others are greedy. Be greedy when others are fearful."

Feinberg walks his talk. During the same period the

Sound Advice on Financial and Energy Funds

Icon Financial Fund was liquidating its Wells Fargo position, Feinberg was establishing what now constitutes 6.3% of the fund, the fourth largest position. Presuming that current prices do not fully anticipate better times for banks, insurance companies and others in this sector, there should be plenty of fuel for a strong profits going forward.

Feinberg has co-managed the fund since 1997, and is now senior manager. Seasoned managers who have shown the ability to outperform peers and indexed funds are ultimately the best choice to generate superior results. However, in the financial services sector good results lately have been nearly impossible. With the exception of the obscure Dryden Financial Services Fund, which chose last year to short financial stocks, no fund dedicated to financials survived 2008 unscathed. However, even as investors fled financials during 2008, inflows to the Davis fund exceeded outflows by $112 million. We don't believe these were brain-dead investors. Instead, we think they recognize the durability of how Feinberg operates.

The fund sticks to nuts-and-bolts value strategies and is willing to buy where others are selling furiously. According to *Morningstar*, the portfolio when compared to the overall financial sector, trades, at significant discounts to Price/Earnings (75% of financials' average P/E), Price/Sales (96%) and Price/Cash Flow (7%) but a slight premium (6%) to book value.

However, the stoic mentality that value investing requires can be two-edged. In market commentary in mid-2007, several months before the market peaked and financials started their implosion, Feinberg revealed value investing's Achilles heel: the assumption that a disciplined value investor in a sector fund can outperform the market. "We do worry," he wrote just before the market would begin to unravel, " about the long-term impact of the twin deficits, rising commodity prices, the possibility of rising inflation, the fast growing use of derivatives, and the potentially negative wealth effect from falling house prices. However, we believe carefully selected companies with competitive advantages, solid free cash flows and earnings growth potential, strong balance sheets, and proven outstanding management that are purchased at attractive prices should perform well for investors over time."

For example, Feinberg in that note focused on two positions: American Express (11.8% of his portfolio), which, as it turned out did not do better than most financials, tracking the financials lower till March 9th and since having a robust rebound , and Progressive Insurance (2.5%), which did outperform as advertised, significantly beating financial stocks as measured by the SPDRs financial ETF (XLF).

Feinberg prefers to make large investments in a relatively small number of companies, and then hold them for extended periods. As of June 30th, the fund holds 32 positions. The four biggest account for 34% of total assets. Feinberg, value investor that he is, leavens the portfolio with relatively small non-financials. Thus, in the current portfolio 4.7% of assets are invested in Canadian Natural Resources, an energy company and Loews Corp (the third largest position at 7.4%), though it does own 90% of CNA Insurance, has about 80% of its value outside of financials. For us, there's nothing wrong with this, especially because we think that Loews is extraordinarily attractive. Just be aware that the fund can invest up to 20% of its assets outside of financial services.

When we say "extended periods," consider the fund's largest position (10.6%), Transatlantic Holdings, a reinsurance firm that backs up primary insurers and focuses on policies for corporate directors and for fire. Feinberg bought his first shares in TRH about a decade ago. The share price, after the bear market, is now back to just about where the shares traded when he first started to accumulate them. We have no problem with patience, especially when TRH stands to benefit from the profound misery major competitors like AIG experienced over the last two years. Feinberg is a buy-and-hold investor. The turnover ratio last year was 9%. During the same period, the average financial services fund turned over its portfolio at a 197% clip.

The fund can be purchased in three versions, the front-loaded A shares, B shares that carry no front-end fee but, should you cash out within seven years, a declining exit or back-end fee.C shares, which have neither a front-end nor a back-end fee but carry the highest expense ratio. These expense ratios for managed financial funds are below average. For our portfolio, we are recommending the B shares, but depending on your investment horizon, either the A shares or the C shares might work better for you.

THE NATURAL CHOICE FOR ENERGY

Selecting a replacement energy fund presents a chance to tighten our focus from a general fund, like Icon or the Vanguard Energy Fund that preceded it in our portfolio, that covers the energy industry's major sectors: oil, natural gas, pipelines and services, to what is the most undervalued segment of the energy market: natural gas (NG).

The question then becomes how to concentrate? Some think the purest investment is an ETF (UNG—NYSE) that supposedly tracks NG prices. Instead, it relies on futures to play energy prices virtually. But futures do not track spot prices and can be distorted by trading strategies. There's another ETF (FCG-NYSE) that tracks a changeable index of natural gas exploration and development companies, but we prefer a vehicle with more flexibility.

> **Given the pain the average fund's shareholders have endured... most investors might want to stay as far away as possible. However, financials have led the market recovery with the average financial fund up 17% year to date and should rise along with a recovering economy.**

This brings us to the only mutual fund that concentrates on natural gas, the **Fidelity Select Natural Gas Fund (FSNGX)**, one of Fidelity's stable of tightly focused sector funds. Fidelity also markets a general energy fund (FSENX) and an energy services fund (FSESX).

During the boom decade for energy, roughly 1998 to 2008, natural gas enjoyed a special place. Because it was cheaper per unit of energy, demand, particularly from electric utilities, was expected to rise. Because NG burns more cleanly than coal or oil, it is less polluting, it was praised as environmentally preferable. Natural gas also is a feeder stock for various plastics and for nitrogen-based fertilizers and has other commercial uses.

Among the three Fidelity sector funds, the Natural Gas fund had the best performance over the last decade, and since energy prices bottomed last November, the Natural Gas fund also put in the best performance, up a walloping 75% but still stands at less than half of where it traded in June 2008.

When the bottom last fall fell out from beneath oil, natural gas followed. However, when oil bottomed in the high $30s at the start of this year and as it then nearly doubled, natural gas didn't get the message. Indeed, the spot price for Henry Hub (Louisiana) Natural Gas today stands at $1.84 per million British Thermal Units (mBtu), a seven-year low. *The New York Times* headlined last week "No Floor In Sight for Natural Gas." We must admit, we like headlines like that, since they usually emerge at price extremes.

The *Times* article certainly fits current market conditions. The most recent numbers released by the Energy Information Administration (http://www.eia.doe.gov/oil_gas/natural_gas/data_publications/natural_gas_monthly/ngm.html) show a 5.3% decline in June for NG consumption while production continues to expand at a 1.4% clip.

As energy prices imploded last year, exploration and development stocks were hit hard, especially companies that had overleveraged themselves by buying assets when energy prices were ballooning in 2007 and 2008.

Under current prices, most producers are trying to throttle back on production. Some like EnCana, are capping wells. Others are developing new wells, piping them into transmission systems but not opening the tap. Others are selling off properties. Drilling rigs are sitting unused, down by at least half since the start of 2009.

All of these cutbacks should support higher prices in the future. But there is another part of the story that the bears love. Supplies are threatening to overwhelm storage capacity. Compared to last June, working underground capacity rose by 27%. Some natural gas bears are laughing about "Peak Natural Gas Storage." It's not just NG from traditional sources that is bulging storage capacity. Over the last few years, accessible reserves for natural gas have increased future supply as developers have been able to tap non-conventional sources, especially reservoirs of NG in shale.

Bears chortle that natural gas prices never will regain double digit levels. However, even though production from shale deposits obviously will impact the market for NG, until the market price for natural gas passes above $4.50 per MBtu, even the most accessible shale deposits are not economically worth tapping.

Why then do we like natural gas and why has money flowed into the sector? At the peak of the energy bull market in July 2008, spot prices for natural gas quoted at the Henry Hub in Louisiana rose to over $13 per mBtu, while West Texas Crude spot prices hit $147 a barrel. The price ratio between oil and natural gas at that point hit 11.3. The fall in oil prices that began off

the July peak of $147 a barrel is stunning, but pales in comparison to the drubbing natural gas took. Oil prices are down more than 50%, but Henry Hub spot natural gas prices have tumbled 84%, and currently stand at are under $2 per mBtu.

Historically, the price ratio between West Texas Intermediate Crude and Henry Hub NG has been about 10:1. But during the mid-2000s, the price for natural gas moved up faster, at least until the super-surge for oil in 2008, than did the price of oil, which brought the ratio lower, approaching 6:1, at which level oil and natural gas provide in dollar terms the same amount of energy. Were that 6:1 ratio to exist at present, presuming WTI crude was at $70 a barrel, Henry Hub NG would be priced above $11 per Mbtu. At current levels, the Henry Hub NG spot price in relation to WTI spot is at an astounding ratio to WTI of around 36.

Our rationale for moving to FSNGX starts with that yawning gap between natural gas and oil prices, and presumes that current spot prices for NG are too low to last. Winter comes. The days get colder. The nights longer. Just as oil prices during the summer of 2008 reached unsustainable levels based on speculation and irrational exuberance, natural gas prices now are being pressed lower for many of the same reasons. Even if current signs that the recession has crested here and abroad prove premature, the issue is not whether but when a meaningful recovery materializes. However, if you are convinced that the end of the world most anticipated in February merely has been postponed, or that the ratio between oil and natural gas prices will shrink not through a rise in NG prices but by a collapse in oil prices, ignore this recommendation.

The Fidelity Natural Gas Fund has been managed by James McElligott since June 2005, so he has been able to manage during both the giddiest and most depressing episodes in the energy sector. He has perspective.

McElligot, after rejiggering the portfolio to his liking during his first two years at the helm, has reduced portfolio turnover. *Morningstar* reports this year that his turnover rate has been 81%, and last year was 68% and 59% in 2007. Compare this to the average energy fund's turnover of 138%.

The fund's charter gives McElligot considerably leeway as regards risk. Depending on how bullish the fund is about natural gas, the manager, when optimistic can overweight the portfolio with energy services and exploration and development companies focused on natural gas, and when defensive he can overweight with utilities and pipeline companies, whose revenues are more or less constant regardless of where natural gas prices are . Currently the fund is weighted heavily toward pure natural gas E&P shares.

Indeed, that exposure explains why last year FSNGX underperformed its peers. In its last report for 2007 (11/30), E&P companies accounted for 52.4% of the portfolio, and among the top 15 positions, which constituted 71% of the portfolio, 11 were E&P companies. McElligott positioned his portfolio aggressively, and paid for it over the following 12 months, which brings us to November 2008 when the market and energy prices bottomed.

You'd not have blamed McElligott, after the punishment his fund was absorbing last year, had he shifted to more defensive positions Instead, he continued to build his exploration and development holdings, more than doubling Chesapeake Energy and Plains E&P and adding Comstock Resources. Nothing seems to have changed since last November. As of the end of May, McElligott upped his Chesapeake position by another third and added Devon Energy, another E&P outfit weighted toward natural gas. In the last SEC filing that showed the portfolio at the end of May, E&P companies account for 59% of the portfolio.

McElligot is sufficiently bullish on natural gas and energy in general to extend the portfolio to alternative energy companies as well. Last November, First Solar appeared in the portfolio, and now SunPower has joined it as the 12th largest position. Making even a modest commitment to solar energy suggests McElligot expects more than just a modest recovery in energy prices, since solar energy, like shale natural gas, only becomes feasible as energy prices run higher than they are today. On the other hand, McElligott could just be a good value investor, picking up depressed shares that need not return or surpass their previous highs to be profitable.That view is reinforced by how McElligott increased the fund's exposure to energy's least progressive sector, coal. Since last November, FSNGX has pushed its investment in Massey Energy from 0.14% of the portfolio to 2.14% at the end of May.

The fund has an expense ratio of 0.85% and discourages in-and-out trades by levying a 0.75% fee for sales within 30 days of purchase. If you think energy going forward is worth your investment dollars, natural gas will work. ***SA***

Portfolio Upates

Since the *Sound Advice* portfolio was last priced on August 7th, it is up 1.5% on a total return basis versus 0.8% for the Dow, 0.6% for the S&P 500, 0.9% for the Nasdaq and a 0.1% loss for the pan-market Wilshire 5000. In that issue, we reviewed five of our funds: **Dodge & Cox Stock Fund** (+1.7%), **Dodge & Cox International Stock Fund** (+2.1%), **Icon Financial Fund** +0.7%), **Third Avenue Value Fund** (+0.4%) and **CGM Real Estate Fund** (-4.5%). Collectively they reflect how the market has done lately. Real estate, which as part of the financial services sector, had been particularly strong since early March, faltered in the last few days. **CGMRX**, however, did better than its benchmarks. Financials, though have been truly bizarre over the last few weeks, stocks like AIG and Fannie and Freddie, with little more than a tenuous future, nearly doubled and tripled. At the same time, more established names weakened somewhat.

Value-oriented stocks continue to do well, which explains the relative success of both Dodge & Cox funds. Though the dollar over the past few weeks has slipped only slightly against other major currencies, we're seeing money going into non-U.S. markets as investors anticipate further weakness in the greenback. The dollar during last year's turmoil did well during periods of extreme pessimism (highs were hit in both November and March as the U.S. equities markets bottomed), and receded as markets regained their balance. The Third Avenue fund, though it has extensive foreign exposure, has it primarily in Hong Kong, whose currency is linked to the U.S. dollar, and thus has not benefited from U.S. dollars seeking the advantage of holding foreign assets.

In the last few days, however, even if the dollar was not giving evidence of severe weakness, gold went into orbit. Over the last three sessions before the Labor Day holiday, gold bullion approached $1000 an ounce, a rise of just under 4%. Gold mining shares, which amplify moves in the metal, were even stronger. The **USAA Precious Metals & Minerals Fund** over three days jumped 14.7%, and is up 11.1% since the last letter.

We anticipate considerably more dollar weakness in the future as markets respond to the inflationary implications of the measures taken to contain the financial crises and the recession. Though we welcome Ben Bernanke's reappointment as Chairman of the Federal Reserve, we do not for a moment believe even he believes he can drain the mega-sized punchbowl before the party turns truly ugly.

If REITs generally were weak, **HRPT Properties Trust** was an exception, as it responded to a solid quarterly report. Fully diluted Funds from Operations (FFO) were 28 cents a share in Q2 2008 and 2009. Occupancy dropped by 0.4% to 89.1%, the result of the spin off of properties that were 99% occupied into Government Properties Income Trust. Looking back to where these shares had fallen in late February and early March on fears that all REITs were about to dry up and blow away, it's hard to understand how the plight of a handful of woefully overleveraged real estate investment companies that were unable to service their debts and/or refinance large notes coming due could have been exaggerated into that an judgment of the entire real estate sector.

Our two REIT preferreds declined. The **Duke Realty Series O Preferred** dropped 5.9% and the **Public Storage Series M** slid 3.9%. Their recovery from the March lows—especially the DRE preferred—was fully expected. What we did not expect was the rush toward par ($25). We continue to like these preferreds for their

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Sound Advice Portfolio for September 2009

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Duke Realty Cumulative Preferred	DRE.PRO	NYSE	$22.21	9.43%	$25.00	BUY
HRPT Properties	HRP	NYSE	$6.58	7.29%	**$7.20**	BUY
Public Storage Cumulative Preferred	PSA.PRM	NYSE	$21.63	7.66%	$25.00	BUY
Diversified Growth					.	
Agrium	AGU	NYSE/TSE	$49.61	0.22%	$56.00	BUY
Boston Scientific	BSX	NYSE	$11.36	0.00%	$14.00	BUY
CarMax	KMX	NYSE	$17.28	0.00%	$21.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	$17.88	4.59%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	$29.78	7.56%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	$88.13	2.07%	N/A	BUY
Fastenal	FAST	NASDAQ	$37.16	1.88%	$46.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	$17.54	1.88%	N/A	BUY
Honeywell	HON	NYSE	$37.15	3.26%	$42.00	BUY
Johnson & Johnson	JNJ	NYSE	$60.32	3.25%	$68.00	BUY
Leucadia National Corp.	LUK	NYSE	$23.96	0.00%	$30.00	BUY
Mattel	MAT	NYSE	$18.43	4.07%	$20.00	BUY
Microsoft	MSFT	NASDAQ	$24.62	2.11%	$26.00	BUY
Molson Coors Brewing	TAP	NYSE	$48.23	2.14%	$52.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	$12.74	0.00%	$14.00	BUY
Perrigo	PRGO	NASDAQ	$29.72	0.74%	$29.00	BUY
Stryker Corp.	SYK	NYSE	$43.47	0.92%	$45.00	BUY
Superior Industries	SUP	NYSE	$14.32	4.47%	$18.00	BUY
Tetra Tech	TTEK	NASDAQ	$29.16	0.00%	$35.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	$42.33	0.43%	N/A	BUY
United Parcel	UPS	NYSE	$53.81	3.35%	$60.00	BUY
UnitedHealth Group	UNH	NYSE	$28.88	0.10%	$32.00	BUY
Wal-Mart Stores	WMT	NYSE	$51.68	2.11%	$60.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	$36.40	5.15%	N/A	**SELL**
Xerox	XRX	NYSE	$8.64	1.99%	$10.00	BUY
Energy/Natural Resources						
Anglo-American PLC****	AAUKY.PK	PINK SHEETS	$16.47	0.00%	$20.00	BUY
Fidelity Select Nat. Gas Fund	**FSNGX**	**800-544-8888**	**$28.05**	**0.00%**	**N/A**	**BUY**
Icon Energy Fund	ICENX	800-764-0442	$15.44	0.75%	N/A	**SELL**
Plum Creek Timber	PCL	NYSE	$28.98	5.80%	**$35.00**	BUY
PowerShares Water Resources ETF	PHO	NYSE	$15.96	0.50%	$19.00	BUY
Transocean	RIG	NYSE	$76.94	0.00%	**$86.00**	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	$30.92	0.03%	N/A	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	$16.33	1.67%	$19.00	BUY
Davis Financial Fund	**DFIBX**	**800-279-0279**	**$22.46**	**8.80%**	**N/A**	**BUY**
Ford Motor Convertible Pfd	F.PRS	NYSE	$29.00	15.41%***	$34.00	BUY
Icon Financial Fund	ICFSX	800-764-0442	$5.55	0.00%	N/A	**SELL**
Liberty Global	LBTYA	NASDAQ	$23.06	0.00%	**$28.00**	BUY
Maxim Integrated	MXIM.PK	NASDAQ	$18.70	4.28%	**$22.00**	BUY
Federated Prudent Bear Fund***	BEARX	800-711-1848	$5.90	0.00%	N/A	BUY
Symantec	SYMC	NASDAQ	$15.65	0.00%	$19.00	BUY
Time Warner	TWX	NYSE	$28.05	2.71%	$34.00	BUY

**Prices as of the market close on Friday, September 4, 2009*
***Yield represents all income during previous 12 months divided by current share price.*
Note that all fund distributions fluctuate annually.
****Dividend Deferred*
*****Note change in ticker symbol*
BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT

income, though at this point with each in the low $20s, we can't expect to capture much more from price appreciation.

Tech did well. **Maxim Integrated**, the analog and integrated chip maker, added 9.3%, **Western Digital** 6.1%, **Microsoft** 5.1%. **Xerox** 2.3%. **Symantec**, still recovering from last month's earnings numbers, eked out a 0.9% gain. The stories across the board are similar: lower revenues, lower margins, lower profits (or smaller losses), though with the exception of Symantec results surpassed expectations. Tech has had relatively superior performance both during the bear and the bull phases of the last 12 months. Investors presume that if we are recovering from recession, their prospects should be excellent.

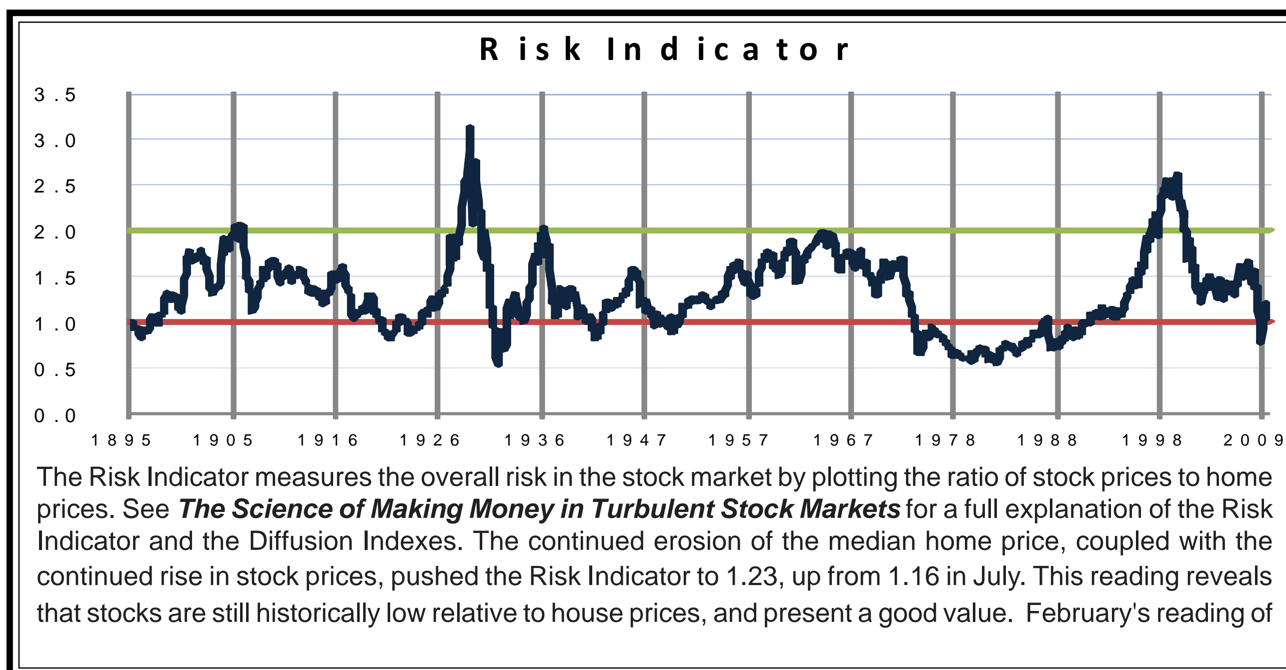
Healthcare, which normally would be seen as a defensive sector that should lag during an economic recovery, also had a good month as it's beginning to be presumed that the most ambitious initiatives sought by President Obama will not survive Congressional politics. That calculation has boosted the sectors, which Wall Street wisdom ever since last fall shunned. **UnitedHealth**, the big HMO in an industry that faced the most serious challenge, added 8.9%. **Odyssey Healthcare**, the hospice provider, moved up 2.8%. **Stryker** added another 8.1%, which follows on a similar gain in the previous month as investors are willing to take in stride poor results during a tough period. Most of the damage, as you recall, came from its hospital and surgical segments (orthopedic replacement parts held their own). Hospitals are deferring making capital expenditures, but can only do so for so long. As for our drug positions, **Johnson & Johnson**, the vast medical conglomerate, added 1.5%. JNJ has been something of a puzzle to us, since it has lagged the recovery both in terms of the overall market and its own sectors. We're OK waiting for the market to notice how cheaply JNJ is trading, how strong its pipeline is and how, with an aging population, its products have significant room to boost revenue for the next 20 years. With a 3.2% yield, given where Money Market rates are, we're content to wait. The big winner in our healthcare stocks is **Perrigo**, which through its over-the-counter non-prescription products, stands to benefit should the coming flu season even approach the ominous warnings we hear. Since the August letter, PRGO is up 11.2%.

Natural resource stocks are having a mixed month. Energy has been up and down as oil approached $75 a barrel before retreating to under $70. **Icon Energy Fund**, which we are replacing this month with the **Fidelity Select Natural Gas Fund**, fell 0.1% while **Transocean**, the deepwater driller, added 2.4%.BP announced a mega-find in the Gulf of Mexico, but it sits below 4132 feet of water and another 31,000 feet of seabed. RIG leases for about $500,000 a day the platform used to reach the reservoir. The good news for RIG is that ultra-deepwater fields are the last frontier for significant energy finds. The better news is that it dominates ultra-deepwater drilling. **Plum Creek Timber** along with other timber stocks have two related problems. First, in a slow economy, demand for wood products has declined. Second, PCL generates a significant portion of its revenue from land sales to developers or to conservation groups. No one is doing much developing lately, and do-gooders, for the moment, are cash strapped. Since the last letter, it's off 17.4%, and is our worst performer. **Anglo-American** is up 3.1%. Our two water stocks had mixed results: the **PowerShares Water Resources Fund** was flat while **Tetra Tech**, one of the fund's biggest positions, fell 3.3% after surging to an all-time high. Water should be a bigger issue for both legislators and the public, but until you turn on your tap and nothing comes out and/or prices per gallon begin to reflect water's real costs, don't expect much. If you want to read an opinionated and pessimistic view of the current state of water infrastructure, look at "Forget Peak Oil, the Real Crisis is Peak Water" (http://www.minyanville.com/articles/peak-water-quinn-minyanville/index/a/24276/p/1).

We also saw declines in auto-related shares, which have had a very strong year. **Superior Industries**, a parts producer, dropped 9.8% and the **Ford Preferred** 4.3%. Both have benefitted from the cash-for-clunkers program, but that's over and investors are taking their profits. No one can ignore every twist and turn in Ford's recovery, but Superior gets almost zero attention. With its bullet proof balance sheet, huge cash position and strong management, it will do very well as demand for vehicles ratchets up not through useful gimmicks like cash-for-clunkers but as the economy and consumers regain equilibrium.

Finally, cable network stocks had a good month. **Comcast** rose 9.2% and **Liberty Global** 5.6%. These are different propositions. Comcast, a more mature operation, is getting a boost from reduced capital expenditures, which should help earnings, while Liberty, which is still in an expansion mode and relies on acquisitions and alliances, is seen as more dynamic as it expands into Asia, Latin America and Europe. We continue to like both. ***SA***

Sound Advice Market Indicators for September 2009



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. The continued erosion of the median home price, coupled with the continued rise in stock prices, pushed the Risk Indicator to 1.23, up from 1.16 in July. This reading reveals that stocks are still historically low relative to house prices, and present a good value. February's reading of

The *Sound Advice* Diffusion Indexes

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. This Diffusion Index currently stands at 0 percent.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual return of 19.8 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		

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.

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 imortannt 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 Supercylce 6 is born. See *The Science of Making Money in Turbulent Markets* for a history of Supercycles (which you received with your subscription). You will also receive an updated copy when you renew your subscription.

Continued Strength

The hand picked leading indicators that comprise our Diffusion Index of Leading Indicators, which are the most sensitive to changes in economic conditions, have shown unusual strength in recent months, rising 1.85 percent in July (the latest reading available), rising 6.8 percent in June, 6.38 percent in May, and 2.71 percent in April.

Such unusually high increases have occurred as we begin recovering from past recessions, and before the recovery was widely recognized. Although it is not indicative of the strength of the recovery, it is an indication that the worst is probably over.

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