SoundAdvice

Hulbert's Honor Roll: 2011 - 2016
For the Best Risk-Adjusted Returns in Both Up & Down Markets since 2000

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The Blinking Game

The *Sound Advice* Portfolio was down 5.7 percent at the end of January, as compared to down 5.1 percent for the S&P 500. We have an average profit of 37 percent based on the prices at which each position was recommended.

Our statistics are based on the assumption that $10,000 is invested in each position. When we recommend adding to a particular position, as we have done over the years, we assume another $10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table on page 9 divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

As always, broad diversification will temper volatility, add to safety, and improve long-term performance.

-- Gray Emerson Cardiff, Editor

The new year was inaugurated with the worst opening week ever. Oil dropped below $30 a barrel briefly, further rattling the stock market.

So, what could possibly be the good news?

As we noted in our January 15 email update, the drop in commodity prices is undermining inflation and will impede the Federal Reserve's mission to normalize interest rates. That is good news for the stock market as a whole. Since then, the market has been showing signs of strength.

The price of oil has also bounced since it dipped below $30. In typical fashion these days, the price of oil and the stock market move in concert. The idea that low oil prices are a net benefit to the economy, and thus the stock market, is not the current perception. This anomaly exists currently because the price of oil is being seen as a barometer of the health of the world economy. However, oil is a separate market, and is being governed by distinct and identifiable forces.

The most significant change in the world's oil market in recent years occurred from the US fracking boom which added nearly 5 million barrels a day to world supplies. That doubled US production. To put the increase into perspective, it is half of Saudi Arabia's output. Once the world's largest producer by a large margin, Saudi Arabia's 10 million barrel per day output was almost matched by US peak production. With oil prices north of $100, US fracking was profitable and it was proliferating. As an oil glut appeared, Saudi Arabia launched a price war aimed at forcing the price of oil down below the cost of fracking in order to drive US frackers out of business. Without that additional 5 million barrels per day on the world's markets, Saudi Arabia and its OPEC allies would be back in the driver's seat again.

It is doubtful that Saudi oil ministers thought that the price of oil would drop as far as it has. During the fracking boom, it cost more than $60 a barrel to produce oil from fracking, and prices just south of that should have done the job. But with large investments already in place, the marginal cost of pumping from existing wells made it practical to keep the spigots open as long as oil spewed.

Today's low price of oil is inflicting pain to Saudi Arabia, which is now grappling with a record $134 billion budget deficit (15 percent of GDP). The Kingdom must cut government spending. It is also reducing energy subsidies for its residents by charging them more for their consumption. At midnight on December 30, petrol and other fuel products were hiked 50 to 80 percent. International Monetary Fund warns that Saudi Arabia, as well as Oman and Bahrain, will run out of cash in 5 years or less with oil under $50.

Who will blink first, the Saudis or the US frackers?

The frackers will not have a choice. The price of oil has now fallen below the cost to frack, causing new US drilling to cease. Existing US production will continue to fall off as a result of the natural steep production curve of fracked oil wells. Production drops 70 percent during the first year from the typical fracked well. Accordingly, a substantial amount of new wells need to be added to maintain production levels. We know that is not happening as evidenced by the 50 percent plunge in the domestic drilling rig count since October 2014.

US production has been tapering off since the first week of June. US production is down by 484 thousand barrels per day from its peak production of 9.6 million barrels per day.

The Iranian Connection

The potential supply coming from Iran is weighing on the oil market. Estimates are that approximately 100 barrels per day will hit the market soon, with somewhere in the vicinity of 500 barrels coming in a year or so. Although Iran will add to world supply, it does not have the ability to flood the market even if it wanted to.

Iran's oil industry needs resuscitating. Decades with little foreign involvement and the devastatingly long Iran-Iraq war in the 1980s crippled Iran's oil industry. Its largest fields have been in production for more than 50 years without adequate attention and maintenance since the Islamic revolution in 1979. Substantial amounts of foreign investment, along with western technology, will be required to raise Iran's production significantly.

Saudi Arabia's price war also targets Iran. Low oil and gas prices make foreign investment in Iran less attractive and impractical. Moreover, oil companies everywhere have dialed back their own capital expenditure budgets in order to survive. 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. It is unlikely that the massive amounts of necessary capital will come to Iran until energy prices have recovered and the outlook becomes favorable.

Iran also claims to have oil in storage, but the vast majority of that oil has sulfur and mercury content that is too high to be competitive on world markets.

Longer-Term

Although it is hard to see now, the longer-term fundamentals of the energy industry have really not changed.

In December, Congress ended the US crude oil export ban established after the 1974 Arab Oil Embargo. The ban was intended to preserve US stockpiles in order to make the US less dependent on imported oil. Evidently, now Congress believes we no longer have to worry about that because of the current oil glut.

As of January 22, the latest week for which data is available, there were 495 million barrels of oil in US storage tanks. During the last 4 weeks, the US imported an average of 7.2 million barrels per day. This means that all of the oil in US storage tanks amounts to only 69 days of oil imports into the US. In 1974, the US only imported 3.5 million barrels per day, slightly less than half of what the US imports today. We are still dependent on imported oil, just as much as we ever have been.

As US production continues to decline and becomes more pronounced, draws from storage tanks are certain to be substantial. That means the US oil glut is not permanent, and will eventually disappear.

Energy Selections

Financial markets anticipate major events ahead of their actual occurrences. As soon as the markets get the first whiff of a decline in the oil glut, energy-related stock prices are bound to rise.

As it has in past cycles, a recovery in oil and gas prices translated into stellar profits. Here are updates on our energy portfolio, in alphabetical order.

Chesapeake Energy (CHK) has taken a beating from the crash in oil and gas prices. The company's debt is trading at a steep discount, indicating the market's concern over CHK's ability to survive given today's low prices of oil and gas. In January, CHK suspended dividend payments for its convertible preferred shares, which will save $170 million a year, which CHK can use to purchase its own debt at a discount. As we reported last month, in the final days of December, the company restructured $3.8 billion of its $11.6 billion debt by exchanging some existing bonds with those of longer maturities. The company is taking steps to survive the current crunch.

CHK's debt load makes it an aggressive investment in the current environment of low oil and gas prices, and the risks increase with an extended period of low oil and gas prices. However, the upside from a recovery is substantial.

Just a few weeks ago, Morningstar (http://www.morningstar.com) lowered CHK's current fair market value valuation to $12 per share from $13. This valuation is close to 4 times the current stock price. Morningstar is dialing back its assumptions regarding future production, but notes that CHK's 9 million net acres represent significant monetization potential in future years as oil and gas prices recover.

Chevron (CVX) reported its first quarterly loss in 13 years at the end of January.

Chevron 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. However, the fourth quarter was an exception. Even the refining divisions reported a loss. Although the company's earnings obviously do not cover the dividend, management has pronounced the annual dividend of $4.28 per share as "sacrosanct."

CEO John Watson states that he remains optimistic on the price of oil in 2016 and that the company can weather the "lower for longer" trend. "We're preparing to live with prices at whatever level. We've made some sharp reductions in our capital spending for 2016 and we expect it will go lower in 2017 and 2018."

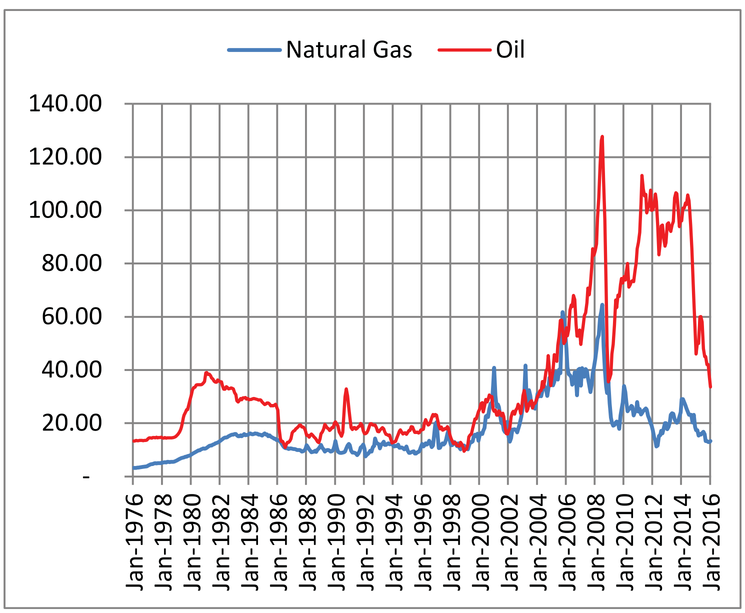
However, a yield north of 5 percent on CVX is evidence that the market is skeptical. The billions used to pay this dividend is not tax deductible to the company and could be used elsewhere to grow the company. It may not be a surprise to see Chevron trimming the dividend if oil and gas prices do not improve measurably in the quarters ahead. The current yield suggests that is the market's expectation, and the stock price may take a trimming in stride.

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 $33.62 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to $2.30 for one million BTUs, 5.8 million BTUs will cost $13.34. So the same amount of energy is available for 40 cents on the dollar, if it is in the form of natural gas rather than oil.

An updated chart follows, 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.

The Cost of Energy Equivalents of Oil and Natural Gas



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. During 2016, management is looking for signs of stabilization in forward looking earnings, and will reposition the Fund as valuations dictate. For example, the recent sell-off of the oil and gas storage & transportation industry has provided an entry point to overweight in this industry.

This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management.

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. We continue to recommend RIG because of its prospects of survival. The company still has a $17 billion backlog with $5 billion in liquidity. 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. Valero is one of the few energy companies that can benefit from lower oil prices because refining margins generally expand during such times. Valero's has the most flexible refineries, allowing the company 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.

At the end of January, VLO posted fourth-quarter 2015 earnings of $1.79 per share which surpassed expectations. The dividend was also increased again, this time by 20 percent to $0.60 per share, for a 3.5 percent yield. During the fourth quarter, the company spent $767 million to buy back stock.

Valero reinvested the balance of its free cash back into its business for future growth, including opening its new crude unit at the Corpus Christi refinery, completing the hydrocracker

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expansion at the Port Arthur refinery, and completing the crude unit expansion at the McKee refinery. Valero also acquired a 50% interest in the Diamond Pipeline that will connect the key oil hub at Cushing, Oklahoma, (the largest storage facility in the US) which will provide better access to cheap domestic crude.

VLO's 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, especially one with solid growth prospects, and a deep discount from the overall market.

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. Based on the latest third quarter financials, we value HT at $29.22 per share. We expect this value to increase because most of HT's major properties have been undergoing renovations and not producing their full income potential. Income is rising from new acquisitions and completed renovations.

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. ROIC also pays an attractive dividend which lowers its risk profile.

During 2015 the company completed a total of $479.5 million of grocery-anchored shopping center acquisitions, encompassing approximately 1.3 million square feet.

In January, ROIC contracted to acquire a two-property California portfolio for $63.3 million. One is the **Magnolia Shopping Center** in Santa Barbara which is currently 97.7% leased. The other is the Casitas Plaza Shopping Center, anchored by Albertson's Supermarket and CVS Pharmacy, in Carpinteria, (within Santa Barbara County), which is currently 100% leased.

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.

Among the latest announcements, in January BSX launched its LithoVue™ Single-Use Digital Flexible Ureteroscope in the US and Europe for minimally invasive endoscopic procedures to diagnose and treat stones and other conditions of the kidney, ureter and bladder.

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.

The latest was in January when BSX announced the development of the ADVANTICS Care Pathway Transformation,. a cloud-based digital health system for hospitals to help improve patient outcomes and reduce costs for treating chronic cardiovascular diseases.

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.

In January, Stryker reported a profit of $522 million, or $1.38 a share, more than doubling results from one year ago. The company forecasts full-year 2016 earnings to be $5.50 to $5.70 a share, with sales increasing 5% to 6%, adjusted for currency fluctuations. 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. In December there was a distribution of $2.7566 per share.

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.

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.

Alcoa Aluminum (AA) was introduced in our December 9 e-mail blog. Alcoa has been crushed along with other commodity stocks. As expected, AA reported a loss for the fourth quarter.

Alcoa is a fully integrated aluminum producer, which means it operates in all phases of production, starting with its mining operations (upstream) and ending with its finished products (downstream). Alcoa's full integration gives it control over the supply chain, and makes it possible to enjoy larger profits from its downstream operations when aluminum prices are low.

In the first half of this year, Alcoa will be splitting its upstream and downstream operations into two separate companies. Management is making this move to unlock value, and we believe it is certain to do just that. Evidently the Elliott Management Corp agrees. The value-oriented hedge fund increased its stake in AA.

Disney (DIS) released its widely anticipated *Star Wars: The Force Awakens* in December in more than 4,500 theaters (the most ever) along with the exclusive use of every IMAX screen in the US. The box office gross of over $1 billion in the first two weeks eclipsed the previous record held by *Jurassic World* which had the benefit of opening simultaneously in China. *Star Wars* opened in China, the second largest market, on January 9.

Disney plans several more episodes and related offshoots of the *Star Wars* franchise into 2019, along with more *Indiana*

Jones movies. More *Avengers* and *X-men* movies are also in the making for 2016.

The success of these movie franchises will add to investor enthusiasm and make DIS less dependent on its cable TV stations, especially ESPN, which are under pressure from cable platforms offering skinnier bundles.

Ford (F) is in our model portfolio because it is an extraordinary value. 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.

At the end of January, Ford reported strong fourth quarter earnings of $0.58 a share, beating analysts' estimates. The aluminum-bodied F-150 pickup finally hit its stride, and SUV sales also surged.

Ford expects 2016 to be as strong or better than 2015, which puts 2016 earnings close to $2.00 a share. This puts the forward price/earnings (P/E) ratio close to 6, which 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 crash in energy and copper prices has thrown FCX into hard times, especially with the company's debt load of $20.4 billion, $2.0 billion of which matures over the next 24 months. Management is focusing on selling assets to reduce debt, not only the oil and gas assets but also mining assets. The company is targeting debt reduction of $5–10 billion. Freeport is also slashing operating costs, suspending dividends, and cutting its capital spending program by $1 billion over the next two years.

As we have reported previously, activist investor Carl Icahn has a stake of 88 million shares of FCX, which makes him its largest shareholder. Mr. Icahn usually has a plan in mind aimed at fixing the current problems, and coercing management into adapting his ideas. These ideas are certain to include a "significant" reduction of its $20.7 billion debt. Meanwhile, at the current price, 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.

In January, NCR announced the launch of its FastLane SelfServ Checkout Release 6, an advanced iteration of NCR's self-checkout systems that features advanced currency recycling capabilities and an integrated convertible option that makes it easy to switch from self-checkout to cashier-assisted mode at peak times.

In December, Blackstone purchased $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 was more than offset by NCR's purchase of $1 billion in NCR stock in the recent Dutch auction.

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.

We have noted 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.

On January 29, the sale of Symantec's subsidiary Veritas closed as expected to the Carlyle Group. SYMC received $5.3 billion in after-tax proceeds. Close to $4 billion is being returned to shareholders primarily in the form of an accelerated share repurchase program.

The sale transforms Symantec into a pure-play security vendor with fresh capital for acquisitions and R&D to bolster growth. 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.

In January, TTEK reported fourth quarter earnings of $0.42 per share, up 2 percent from the same quarter last year.

TTEK also closed on the acquisition of Coffey International in January, which is a good fit and should improve TTEK's growth in the next few years. Coffey's international development division will help TTEK implement the numerous overseas contracts awarded to it in 2015. Coffey's Geoservices division can take over TTEK's low-margin work in this area. Most importantly, Coffey will give TTEK an entry into Australia to expand its strongest area, water engineering services.

At the end of January, the Company announced it needed to purchase $75 million of TTEK to complete its most recent share repurchase program.

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 (I.T.) services, and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenue. We have been emphasizing that XRX is very cheap relative to the rest of the market, and a good value.

Evidently, Carl Icahn agrees. He recently purchased 82 million XRX shares, close to 8 percent of the outstanding shares. Icahn typically buys undervalued stock in companies where there is something to fix in order to unlock value. He likes to spin-off non-core assets and put the capital to better use. Icahn also likes to separate business segments to improve management efficiency and focus, which is what he is doing this time -- splitting the company into two, one company with the printers and other equipment, and the other offering the I.T. services.

Xerox and Icahn reached a deal on the governance of the I.T. services company. Icahn gets to name three of the nine directors on that company's board. A search is also going to be started for an external candidate to serve as CEO, which Icahn must approve, and Icahn will advise the committee that is performing the search.

Last month we said that Icahn's actions are bound to be positive for both the near term and long term prospects for XRX. Icahn has since issued a written statement that he believes the independent business process outsourcing company will enhance shareholder value.

ETFs for Rising Interest Rates

We are recommending three ETFs designed to benefit from the normalization of interest rates and long term bond yields. 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.

We can project the movements of these ETFs based on any given scenario. In its December meeting, the Federal Reserve's Federal Open Market Committee (FOMC) unanimously decided to begin normalizing interest rates. It increased the Federal Funds rate to range from 0.25 to 0.5 percent from the near zero level established 7 years ago to bail out the economy from the 2008-09 melt-down. Now that the normalization process has begun, the critical question now becomes how fast will interest rates rise?

As part of the FOMC's economic projections, each of the 17 members 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 most recent Dot Plot taken at the December meeting predicts that the Federal funds rate will be 1.375% by the end of 2016. Of particular interest in the details of these Dot Plots is the sharp difference in the predictions among this group of informed FOMC experts. The lowest prediction was that the Federal funds rate would end 2016 at 0.875 percent. The highest was 2.125 percent. That is a big difference and represents two diverse scenarios.

The low prediction assumes the recent low interest rate environment will continue. In order for that to happen, three major trends must remain in force:

Energy prices would continue declining throughout the year.

In addition, quantitative easing and expansionary monetary programs would need to continue outside the US without having the desired effect of stimulating economies abroad.

Most importantly, the US inflation rate would need to remain near zero.

On the other hand, the high end of the 2016 FOMC prediction of 2.125 percent assumes that all three trends will be reversed.

Long-term Treasury bond yields generally move in accordance with changes in short-term rates because investors usually want a real rate of return (above the inflation rate) in the proximity of 3 percent. Such is the case today. Inflation, including food and energy, has been bouncing around at zero to 0.3 percent annual rates during the last several months. Long-term Treasury bond yields closed at 2.76 percent on January 29 with the Federal funds rate at 0.25 percent, for a real return of 2.51 percent.

If we assume long-term Treasury bond yields rise by the same amounts (to preserve the same as today's real return) as the medians of the December Dot Plot, long-term Treasury bond yields would be yielding 3.885% by the end of 2016, 4.885% by the end of 2017, and 5.76% by the end of 2018. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 1.885% over the inflation rate at the end of 2016 and 2.885% over the inflation rate at the end of 2017.

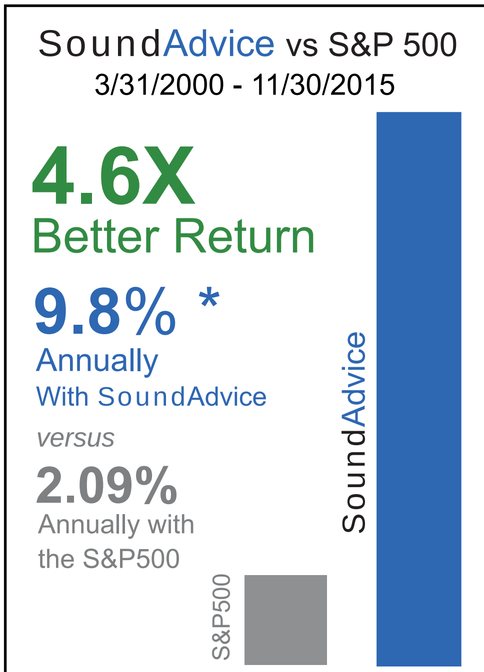
Here is what would happen to each ETF:

TMV would rise to $42 by the end of 2016, to $67 by the end of 2017, and to $97 by the end of 2018.

TBT would rise to $58 by the end of 2016, to $79 by the end of 2017, and to $101 by the end of 2018.

TBF would rise to $30 by the end of 2016, to $35 by the end of 2017 and to $39 by the end of 2018.

For context, we can look at scenarios for the low and high ends of the December Dot Plot projections.



*Calculated by the Hulbert Financial Digest

The Low End

The lowest points of the December Dot Plot predict that the Federal funds rate will be 0.875% by the end of 2016, 1.875% by the end of 2017, and 2.125% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these lowest points, long-term Treasury bond yields would be yielding 3.385% by the end of 2016, 4.385% by the end of 2017 and 4.635% by the end of 2018. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 1.385% over the inflation rate at the end of 2016 and 2.385% over the inflation rate at the end of 2017. These are historically low real rates of return.

Here is what would happen to each ETF:

TMV would rise to $33 by the end of 2016, to $53 by the end of 2017, and to $59 by the end of 2018.

TBT would rise to $49 by the end of 2016, to $68 by the end of 2017, and to $73 by the end of 2018.

TBF would rise to $26 by the end of 2016, to $31 by the end of 2017, and to $32 by the end of 2018.

The High End

The highest points of the December Dot Plot predict that the Federal funds rate will be 2.125% by the end of 2016, 3.375% by the end of 2017, and 3.875% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these highest points, long-term Treasury bond yields would be yielding 4.365% by the end of 2016, 5.885% by the end of 2017, and 6.385% by the end of 2018. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 2.365% over the inflation rate at the end of 2016 and 3.885% over the inflation rate at the end of 2017. This scenario is reasonable for 2016 but implies that inflation would be rising above 2% in 2017 and required additional tightening by the Federal Reserve.

Here is what would happen to each ETF:

TMV would rise to $60 by the end of 2016, to $105 by the end of 2017, and to $126 by the end of 2018.

TBT would rise to $74 by the end of 2016, to $107 by the end of 2017, and to $120 by the end of 2018.

TBF would rise to $32 by the end of 2016, to $38.5 by the end of 2017, and to $41 by the end of 2018.

A Matter of Degree

At the moment, the low end scenario seems most likely in view of the deflation of commodity and oil prices, along with the apparent softness of the major economies outside the US. It is also natural and easiest to assume that present circumstances will continue for the foreseeable future. However, a number of factors could change the outlook dramatically, including a recovery of energy and commodity prices. A mere stabilization would remove downward pressure on US inflation.

Last week, the Central Bank of Japan moved to negative interest rates, joining the European Central Bank along with the central banks of Sweden, Denmark and Switzerland. Negative interest rates abroad provide downward pressure on US interest rates for the near term. However, as these highly stimulative monetary programs gain traction, these economies will show more life. That will be a world-wide game-changer, pushing inflationary expectations and interest rates up around the world.

Under all of the above scenarios, there is considerable upside in these ETFs from their current prices. It is only a matter of degree.

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.

Hedging the Portfolio

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. Just to eliminate the possibility of a fluke reading, we note that there have been 8 subsequent readings of 100 percent in a row, including the most recent reported in January for December. (Just one would be sufficient for a caution signal).

From this perspective, we can conclude that stocks in

Income With Growth	Symbol	Price / NAV	Yield	Action	Upper Limit
Hersha Hospitality Trust	HT	$17.57	6.37%	BUY	$21.00
Retail Opportunity Investment Corp	ROIC	$18.49	3.24%	BUY	$19.00
Diversified Growth					
Agrium	AGU	$86.87	4.03%	BUY	$95.00
Alcoa	AA	$7.29	1.65%	BUY	$9.00
Boston Scientific	BSX	$17.53	0.00%	BUY	$19.50
Disney	DIS	$95.82	1.38%	BUY	$99.00
Ford Motor Company	F	$11.94	4.19%	BUY	$16.00
NCR Corp	NCR	$21.34	0.00%	BUY	$25.00
Pfizer	PFE	$30.49	3.67%	BUY	$33.00
Stryker Corp.	SYK	$99.15	1.07%	BUY	$105.00
Symantec	SYMC	$19.84	3.02%	BUY	$23.00
Tekla Life Sciences Fund	HQL	$18.16	0.00%	BUY	$20.00
Tetra Tech	TTEK	$26.49	1.21%	BUY	$27.00
Third Avenue Real Estate Value Investor	TVRVX	$26.11	1.69%	BUY	$30.00
Third Avenue Small-Cap Value Investor Fund	TVSVX	$17.60	0.00%	BUY	$20.00
Xerox	XRX	$9.75	2.56%	BUY	$11.00
Energy/Natural Resources					
Chevron	CVX	$86.47	4.95%	BUY	$95.00
Fidelity Select Nat. Gas Fund	FSNGX	$19.16	1.72%	BUY	$23.00
ICON Energy Fund Class S	ICENX	$10.60	0.85%	BUY	$12.00
Transocean	RIG	$10.42	0.00%	BUY	$11.00
Valero	VLO	$67.87	3.54%	BUY	$75.00
Aggressive Growth					
Chesapeake Energy Corp	CHK	$3.39	0.00%	BUY	$5.00
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	$23.57	0.00%	BUY	$28.00
ETF - ProShares Short 20+ Year Trsry	TBF	$23.44	0.00%	BUY	$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	$39.42	0.00%	BUY	$42.00
Freeport-McMoRan	FCX	$4.60	0.00%	BUY	$6.00
S&P 500 ProShares Ultra Short ETF	SDS	$21.86	0.00%	BUY	$24.00

This table has live prices, charts & buy limits on our website: http://www.soundadvice-newsletter.com/members

Notes to the table:
Prices are as of 1/29/2016. See our website for live pricing and buy limits:
http://www.soundadvice-newsletter.com/members
The right hand column is the highest recommended price limit for purchases.

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.

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.

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 $11.3 million in stocks and to $1.58 million in houses.

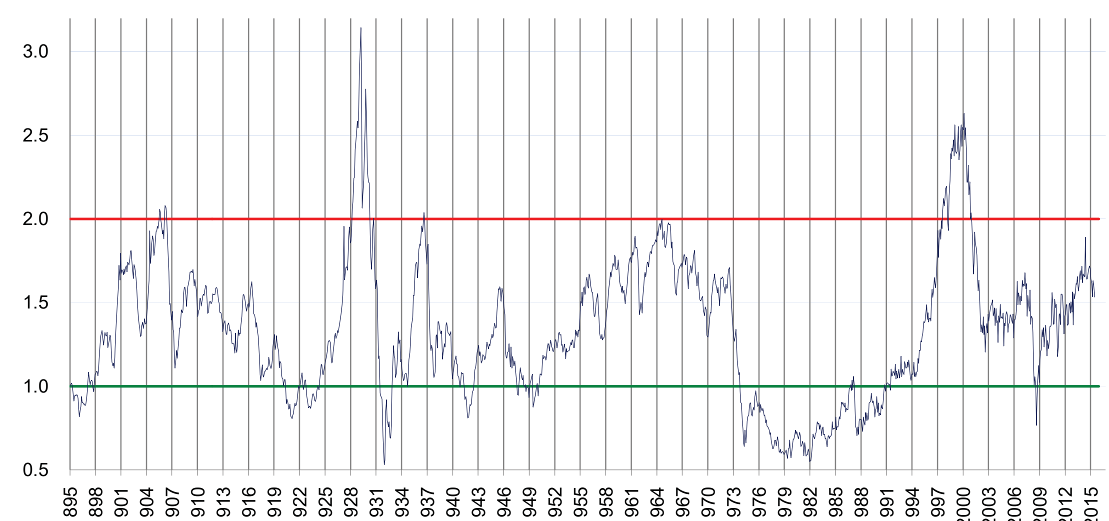
But though an investment beginning with $25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made $450 million, or 39.7 times more money—the 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 1.53. This reading reveals that stock prices are close to 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 31.5 percent. During "Caution" signals, the S&P 500 increased an average of 1.9 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 +/-	31.5%		1.9%

See ***The Science of Making Money in Turbulent Markets*** for a complete explanation of the **Sound**Advice 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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