

## Green Light, Red Light



### Greeks Bearing Gifts

The drama in Greece over the weekend rattled the market today. Greece's problems will not be over until the current left-wing regime comes to its senses, is ousted, or resigns. Until then, the problem is unlikely to spread to other countries because the Greek GDP represents less than 2 percent of the Eurozone. Any contagion to other countries will be noticeable by runs on banks and ATMs, or unusual capital flows, especially after the election of an extreme leftist leadership. Hopefully the Greek example will deter any future notions in that direction in other Eurozone countries.

Still, the US stock market is vulnerable for other reasons, which are explained in this Issue. This means the market does not need much of a catalyst for a significant correction.

It is time for us to be defensive.

Even after today's downdraft, the *Sound Advice* Portfolio is up 5.3 percent since the beginning of 2015, as compared to down 0.06 percent for the S&P 500.

We have an average profit of 59 percent in the *Sound Advice* portfolio, based on the prices that each position was recommended.

Best regards,

-- Gray Emerson Cardiff

It's like the childhood game: move when you hear "green light" and freeze when you hear "red light". If you don't freeze on "red light", you are out of the game.

We rely heavily on our Diffusion Indexes (page 11) to give us green and red lights. Our Diffusion Indexes have been extremely reliable in guiding us through the major movements in stocks caused by the business cycle.

We recently had a green light from our Diffusion Index of Leading Indicators, which gave a zero reading in March, 2015. This reading revealed that the economy had softened and was providing an atmosphere for low interest rates. This reading was confirmed by the reluctance of the Federal Reserve to begin normalizing interest rates by initiating the first increase in the Federal Funds rate since they were set at zero to bail out the economy from the 2008-09 melt-down. Chair Yellen said in a recent speech: "*To support taking this step, I will need to see continued improvement in labor market conditions.*"

That is now likely to be sooner rather than later. That is because our Diffusion Index of Lagging Indicators (page 11) just hit 100 percent, based on the most recent economic indicators released in June (for May) by the Commerce Department. This reading is a "red light", warning us that the economy is firming up and is now providing an atmosphere for rising 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. Another example was in June 2000, just as that bear market was getting underway.

A signal from this Diffusion Index does not always predict a crash or decline. It can be trumped by a deliberate Federal Reserve policy, such as the signal in March, 2012. Although the economy was firming up, the Federal Reserve continued to embark on its quantitative easing (QE) programs, forcing interest rates to remain low. Although we were operating under a caution signal then, we remained bullish on stocks because we could see that the Federal Reserve was going to hold short-term rates artificially low to stimulate the economy.

That is not the case now. The Federal Reserve has been promising to start the normalization process by commencing interest rate increases in 2015. It has only been a question of exactly when.

Confirming the new economic strength revealed by our Diffusion Index of Lagging Indicators is the latest reading in consumer spending. This is a very significant indicator because consumer spending accounts for two-thirds of the US Gross Domestic Product (GDP). In late June, the Commerce Department reported that consumer spending rose 0.9 percent in May, the largest gain since August 2009, when the government's "Cash for Clunkers" program fueled auto-buying.

### The Big Picture Indicator

With the price/earnings (P/E) ratio hovering close to 17 for the S&P 500, there is a consensus among analysts that stocks in general are fully valued. Many argue that prices are on the high side. The problem with these comments is that they do not offer context.

One of the best ways to establish perspective is to measure the ratio of the total capitalization of the stock market (stock prices of all publically traded

## Total Stock Market Capitalization versus the US GDP



Sources: Federal Reserve, U.S. Bureau of Economic Analysis, [www.vetorgrader.com](http://www.vetorgrader.com)

companies multiplied by their respective amounts of shares outstanding) to the gross domestic product (GDP) of the US.

Above is a historical chart of this ratio. The ratio rose above 1.2 in the late 1990s prior to the 2000-02 bear market that took stocks down nearly 50 percent. It also rose above 1.1 just prior to the 2008-09 bear market which took stocks down nearly 50 percent again. Currently, this ratio is close to 1.3.

From this perspective, we can conclude that stocks in general are dangerously high, particularly with rising interest rates on the horizon and our Diffusion Index of Lagging Indicators flashing a caution signal. Accordingly, it is an appropriate time to introduce an ETF that will benefit from a declining stock market.

The **ProShares UltraShort S&P 500 (SDS)** is a reverse ETF that is designed to produce two times the daily fluctuations of the S&P 500 index. It works in the same way as our No-Brainer ETFs. For example, a decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

As with any reverse ETF, SDS will erode slightly over a long period of time because it will decline slightly more than it will increase with an equal movement in the S&P 500. The

erosion factor is nominal in comparison to normal market movements, but it can add up over an extended period. The 2:1 leverage amplifies this erosion factor as well.

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

## Portfolio Updates

When stock prices are generally high, it is exceedingly important to emphasize value. Here are updates on the rest of our portfolio.

### Energy Selections

As one of the few deeply discounted values left in the market, carefully chosen energy stocks are bound to enhance the long-term performance of our portfolio, even in a declining market. Keep in mind that the US still imports close 6.77 million barrels a day, which begs the question: Why not use up our oil glut, and import less oil? It would not take long to use up the glut. There are currently 463 million barrels of oil in US tanks, 74.9 million barrels more than one year ago when there was no glut. This difference is 11 days of our imported oil needs. Even every drop of the entire 463

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million barrels in all US storage tanks equates to less than 70 days of imported oil. Here are updates to our energy portfolio, in alphabetical order.

**Chevron (CVX)** is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling for oil, to transporting and refining, and even to retail sales at its gas stations. Profits from these various stages of production will change with the price of oil. When oil prices are high, margins are high from drilling, while margins are low from refining. However, the reverse is also true when oil prices are low.

The dividend is currently \$4.28 per share. The depressed price of the stock puts the yield above 4 percent. This yield does not happen often. The last time was during and shortly after the 2008-09 melt-down.

Although there is a glut of natural gas at the moment, natural gas is poised to see the greatest growth in market share of all fuel types in the years ahead. As we point out regularly in these pages, a substantial disparity still exists between the energy equivalent costs of oil and natural gas, which translates into an expanding natural gas industry.

Natural gas can be compressed and chilled to -260F into liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia, where demand and prices are much higher. In Europe the price of natural gas is three times higher than in the US. Prices are close to four times higher in Asia.

Chevron is expanding its LNG deep-water infrastructure for its offshore natural gas reservoirs with two LNG projects underway in Australia. The one in Gorgon is starting up this year. The other is Wheatstone, with nine production wells that have been drilled to the top of the gas reservoir, which is scheduled to begin in 2016. Premier LNG buyers have contracted to buy 85 percent of the production from these gas reservoirs.

**Chesapeake Energy (CHK)** is the nation's second largest producer of natural gas next to Exxon Mobil. The stock price has declined due primarily to the current glut in natural gas. The market is also nervous about CHK's commitment to forge ahead to develop its prime properties while other producers are cutting back.

For example, CHK recently began operations on 600 of its undrilled sites at Eagle Ford, and it still has 4,500 more. This drilling is expected to improve CHK's proven reserves by 76 percent in the Eagle Ford. CHK has been able to cut drilling costs, which are 33 percent lower than they were one year ago.

Chesapeake has over 9 million net acres of oil and gas assets in prolifically producing areas, including the Marcellus and Utica Shale, as well as the Eagle Ford and Anadarko Basin. CHK is forging ahead on its drilling plans to hold and develop production from this prime acreage.

As of mid-May, Morningstar's fair value estimate for Chesapeake was still \$27 per share, more than double the current price of this stock.

As CHK declined earlier this year, Carl Icahn bought another 6.6 million shares, increasing his stake to 11 percent of the company.

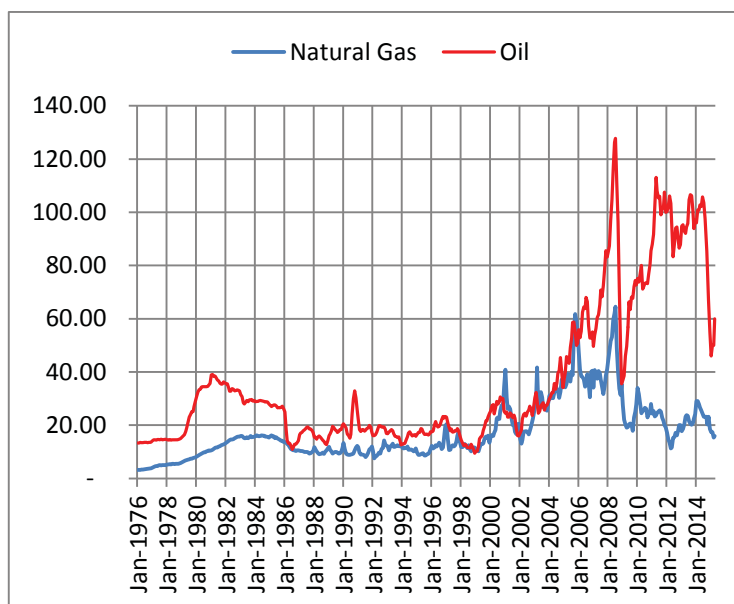
**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly.

The growth outlook is bolstered by new facilities coming on line to transport US natural gas to the rest of the world. On the Louisiana coast, the largest super-cooling facility for natural gas (the Sabine Pass liquefaction terminal) is scheduled to be completed later this year, and will chill natural gas into liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia. This will be the first facility to export LNG from the contiguous US. Two more such facilities are scheduled for completion in 2018.

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 \$60 a barrel, that is the cost of 5.8 million BTUs. However, with a market price for natural gas close to \$2.75 for one million BTUs, 5.8 million BTUs will cost \$15.95 (5.8x\$2.75). So the same amount of energy is available for 27 cents on the dollar, if it is in the form of natural gas rather than oil.

The chart below shows 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 moved closer together when the price of oil dropped, but remain substantially apart. This difference

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



still translates into an expanding natural gas industry.

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

In the past, this fund has achieved growth even during periods of declining energy prices. ICON management looks 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.

The fund did not drop along with the price of oil. It declined 5 percent in 2014 but is up by that much this year; all during a 50 percent drop in the price of oil.

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

**Transocean (RIG)** has been hammered by the sharp drop in oil prices. In February, RIG cut its dividend to 60 cents per share, which was not a surprise in view of the oil price crash. The current 60 cent dividend, which is not likely to be lowered again, is a solid 3 percent yield. This puts a floor in the vicinity of the current stock price because any substantial drop in the stock price from here would cause the yield to increase materially, which would be out of line with the industry.

It is important to keep in mind that the US still imports nearly half of its oil needs. Deep water drilling is still a necessary source for the US and the world's oil needs. 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. VLO is an extraordinary investment value and in a highly-unique position to profit from the oil glut that is plaguing the US oil industry. The company also has 7,400 retail outlets in the US, Canada, UK and Ireland, under the brands Valero, Beacon, Ultramar, Shamrock, and Texaco.

Most US refineries are not set up to handle the light, sweet, crude oil that is coming from fracking US shale. Prior to the boom, world oil production had been shifting toward heavier and more sour crudes coming from Canada, the Middle East, Mexico, and the US Gulf Coast. Therefore, a primary cause of the US oil glut can be explained by the inability of most US refineries to process light sweet crude oil from shale.

Valero's refineries are notable exceptions because they are the most flexible refineries, thanks to strategic capital spending in recent years. Valero's refineries can process just about any variety of oil, from light to heavy, sweet to sour. Its refineries are currently running at an industry high of 95 percent capacity, refining 2.9 million barrels per day. This refining flexibility allows Valero to capture the highest margins among its competitors because it is able to capture the best crude oil price discounts at any given time.

Valero's refineries are also well positioned geographically, with refineries scattered across the US, which can take

advantage of discounts from local capacity gluts. Its Gulf Coast refineries give it a particularly strong advantage because they are in the proximity of the Eagle Ford, one of the most prolific shale formations in the US, and Valero is expanding its facilities there, at its Three Rivers and Corpus Christi refineries.

The Gulf Coast refineries are also well-located for accessing the low-cost Maya crude from Mexico, a heavy sour oil that Valero bought in 2014 for an average \$13 per barrel discount, which was an ever larger discount than from US oil.

The company is also increasing its rail-car capacity to move discounted light crude fracked from the Bakken Shale in North Dakota to its California refineries. Depending on discounts, Canadian heavy crude may also be transported to California as well as the Gulf Coast.

The discounts in the prices of crudes Valero was able to use in 2014, along with solid demand for gasoline products, improved margins by \$1.9 billion, or \$1.59 per barrel over the previous year. During the first quarter, refining margins increased by \$1.49 per barrel over the same quarter last year, to \$12.39 per barrel from \$10.90. These margins translated into company earnings of \$1.87 per share from \$1.54 one year earlier.

Another advantage Valero has is its highly successful Master Limited Partnership, **Valero Energy Partners LP (VLP)**. This gives VLO the ability to "drop-down" assets to VLP at higher prices that could likely be obtained on the open market, effectively "unlocking value" for VLO shareholders. Eligible drop-down assets in 2015 include over \$1 billion of pipelines, terminals, storage tanks, and railcars. In March, VLO had a \$671 million drop down to VLP of its Houston and St. Charles Terminal Services Business.

Despite its success, VLO remains an under-valued stock. Earnings are expected to be \$6.85 per share in 2015, which puts the price/earnings ratio (P/E) at 8.6, far below the industry average of 12.6, and far below the S&P 500 average of close to 17. Other measures also reveal VLO is undervalued: Price/book value is 1.5 versus 2.2 for the industry. Three-year net income growth is 20.2 percent, versus the industry's average of 5.5 percent. The past and expected future growth rate should support a much higher P/E.

In addition, VLO raised its quarterly dividend two quarters ago, to 40 cents per share from 27 cents, giving it a yield of 2.7 percent. Valero also has a lower debt to equity ratio of 30 percent in comparison to the industry average of 50 percent.

Valero Energy is one of the few energy companies that can benefit from lower oil prices because margins expand during such times. However, high demand for gasoline during times when oil prices are rising provide good margins too.

Valero bought 5.4 million of VLO in 2014, and 7.1 million

more so far this year.

### The No-Brainers

We are recommending three ETFs designed to benefit from the inevitable rise in long-term Treasury bond yields. These ETFs differ in the amount of leverage used:

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.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance. We have dubbed these ETFs as “No-Brainers” because interest rates and bond yields always rise during an economic recovery. The ascent has never been smooth and this time has been no exception.

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 with an average maturity length of close to 27 years. The prices of our No-Brainer 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.

As part of the Federal Reserve’s economic projections, each member of the Federal Open Market Committee (FOMC) makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called “Dot Plot”, and medians are taken to formulate the Federal Reserve’s official prediction.

The most recent Dot Plot from the June FOMC meeting predicts that the Federal funds rate will be 0.625% at the end of 2015, up from zero currently. The Federal funds rate is predicted to be 1.625 percent at the end of 2016 (revised from 1.875% in the March FOMC meeting), and 2.875% by the end of 2017 (down from 3.125% in the March Meeting). Over the longer run, the consensus was unchanged, ranging between 3.25% and 4.25%, with the median of 3.75%.

The latest Dot Plot was taken in view of the weakness in the first half of the year, and will likely be revised upward as the economy improves. However, assuming Treasury bond yields move in accordance with the latest Dot Plot predictions of the Federal Funds rate, here is what would happen to each ETF:

TMV would rise to \$46 by the end of 2015, to \$84 by the end of 2016, and to \$144 by the end of 2017.

TBT would rise to \$61 by the end of 2015, to \$91 by the end of 2016, and to \$130 by the end of 2017.

TBF would rise to \$29 by the end of 2015, to \$35 by the end of 2016, and to \$42 by the end of 2017.

### Real Estate Selections

A rising interest rate environment is a negative factor for real estate. However, a rising economy will also push up rental rates which will more than compensate for any added interest expense. On balance, the combination will be positive on well-valued real estate. The problem is that low interest rates for so many years have created bubbles in some markets. The most obvious is in the bond market. What is less obvious is in the commercial real estate market.

Commercial real estate prices are based on the net income the properties produce, before debt payments are considered. In real estate parlance, it is called a capitalization rate (cap rate), but it is the same thing as a bond yield. As in the case with bond yields, cap rates on commercial real estate have declined to historically low levels, pushing commercial real estate prices historically high. Now that an uptrend in interest rates is imminent, commercial real estate in general does not present a particularly good value.

We were happy to see our recommendation of Associated Estates (AEC) go for sale at a low cap rate on its underlying apartment portfolio. We made a 100+ percent profit from our recommended purchase when the stock was at a discount to its net asset value.

With valuations historically high in general, we are no longer comfortable with the real estate sector of the market, and the investments that are based on the broad REIT indexes, including the [Vanguard REIT Index Investor Fund \(VGSIX\)](#) right now, or any of the alternatives: the [Vanguard REIT Index Fund Admiral Shares \(VIGSLX\)](#), or the [Vanguard REIT ETF \(VNQ\)](#). We are selling these index funds.

REIT index funds were stellar performers last year, producing returns above 30 percent. In normal markets, they tend to out-perform most other sectors, and we will be returning to them in the future. But right now, there are better places for our money, where extraordinary values exist. In real estate, those are in our other real estate selections. Here are updates on those, in alphabetical order.

[Hersha Hospitality \(HT\)](#) is selling at a discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from a strengthening US economy. In addition, nearly a third of its major properties have been undergoing renovations and not producing their full income potential. HT saw the beginning of the benefits from completed renovations and new acquisitions during the third quarter of 2014.

In June, HT added to its portfolio by contracting to buy the 155-room St. Gregory Hotel & Suites in Washington, DC, for \$57.0 million. This hotel will immediately benefit HT’s revenue and growth prospects. The hotel’s 155 rooms were recently renovated, and two-thirds are suites with kitchens. The purchase price is based on a capitalization rate of 7.0 percent, which is a good value today.

Since our last Issue HT has had a 1-for-4 reverse share

split. The dividend is now 28 cents per share. The split does not change our favorable recommendation on HT and should enhance its value because the post-split price will put HT more in line with the stock prices of its peers. It also offers investors reduced trading costs as well as lower administration costs for the company.

Hersha management states that it will continue to employ opportunistic stock buybacks to enhance total returns. To date in 2015, 6.6 million shares of HT, totaling \$42.4 million, have been repurchased by the Company.

Management says there is currently a large variance between the current trading price and the Company's net asset value. We agree. Based on the most recent four quarters, we estimate the net asset value (NAV) of Hersha's hotel properties is at least \$27.80. However, the full benefits from HT's acquisitions and renovations have yet to be realized. We expect the NAV of HT to increase in the immediate quarters ahead.

**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) is bound to continue to rise, along with the dividend, and push the price of this REIT upward. ROIC pays an attractive dividend of close to 4 percent, which lowers its risk profile.

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

Management has a similar approach to ours because management 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. 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).

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.

### Medically-Related Selections

In the final days of June, the Supreme Court upheld the validity of subsidies for health insurance premiums for low-income customers created under the Affordable Care Act. This is a positive development for the industry as evidenced by the positive reaction to the news by medical insurance stocks. Generally this sector is defensive, even though price/earnings ratios may be higher than the S&P 500. Medical needs persist regardless of financial conditions, and the increase in medical care needs, caused by global demographic aging trends, offer strong inexorable growth prospects for this industry. Here are updates in this section of our portfolio, in alphabetical order.

**Boston Scientific (BSX)** has medical products that are well suited for an aging population in the US. 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.

The most significant recent approvals are in the cardiac care arena, including the *Watchman* Heart Device (implanted on the left atrial appendage of the heart to prevent blood clots from atrial fibrillation) and its *Subcutaneous Implantable Defibrillator* (implanted under the skin to provide protection against sudden cardiac arrest) as well as its *Lotus Valve* system (an aortic valve implantation device for severe aortic stenosis).

BSX's partnership with the Chinese surgical stapler maker, Frankenman Medical Equipment Company, offers promising growth prospects because China is one of the world's largest and fastest-growing medical device markets.

**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 most recent to receive approval was *Palbociclib*. Trade-named "Ibrance", treats one of the deadliest forms of breast cancer by inhibiting two enzymes that promote the growth of cancer cells. It is expected to be a blockbuster for PFE, producing \$4 billion in sales by 2020.

Pfizer's current top selling drugs include *Lyrica* (for pain and fibromyalgia), *Prevenar* vaccines (for pneumonia and other infections), *Eliquis* (for non-valvular atrial fibrillation),

and *Xeljanz* (for rheumatoid arthritis).

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

Stryker's cash-rich balance sheet and strong cash flow gives SYK avenues for continued diversified growth through acquisitions. Recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, and MAKO Surgical, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

Stryker is buying back \$2 billion of SYK in 2015, following the purchase of \$100 million in 2014.

**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. They also tend to be domestic companies. Without substantial overseas exposure, small caps are not buffeted by currency fluctuations, and they are not suffering from the negative effects of a strong dollar that are likely to continue to haunt larger companies. Of course, 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.

Small-cap stocks perform better than large-cap stocks over the longer term 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.

### 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)** has a broad mix of agricultural products and services that increases 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. The combination of worldwide population growth, without commensurate expansion of farmland, translates into a need for greater crop output per acre through the use of the products that Agrium provides.

Agrium derives close to half of its revenue as the largest agricultural retail operator in the US from its 750 retail farm stores, offering seeds, fertilizers, and other crop chemicals directly to farmers. The retail network stretches across the country which allows collection of important weather, soil, and pest information which is used to gauge buying patterns. Agrium is continuing to add retail centers, which are an important source of growth and gives the company bargaining power with suppliers.

The other half of Agrium comes mainly from wholesaling fertilizer products. The company recently finished expanding its Vanscoy potash mine, which more than doubles Agrium's potash capacity.

Agrium is also expanding its nitrogen production capacity through its Borger nitrogen facility, along with other expansions in Egypt and Argentina. The company's nitrogen production in Alberta continues to have good margins because of access to cheap natural gas.

AGU is trading at a P/E ratio below that of the S&P 500. The annual dividend increased in the first quarter to \$3.50 per share.

**Ford (F)** is depressed because of down time and preparation for 24 new or refreshed vehicles. Ford's new all-aluminum F-150 truck 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. Sales have been held back this year because the Kansas City facility has not been able to produce enough F-150 models. However, production capacity is scheduled to increase sharply within two months and catch up with demand.

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 ability to adapt to changes in demand.

Ford is selling at close to 10 times earnings, a deep discount to the rest of the market, with good growth prospects.

**Freeport-McMoRan Copper & Gold (FCX)** is the world's largest copper producer. Copper is woven into the fabric of the world's developed economies, and its price moves

dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. As the world's economies continued to expand into 2008, so did FCX.

At close to the top of the market in 2013, FCX decided to diversify by making a major acquisition of oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. The ownership of these assets, and the debt incurred for the acquisition, caused FCX to suffer, along with the general decline in energy stocks.

We reported last month that the company planned to continue developing these assets and may finance the project by spinning off these oil and gas properties through a public offering. Since then, the company has taken steps in that direction. In June, FCX filed for an initial public offering of up to \$100 million in common shares, and intends to apply for listing on the New York Stock Exchange for a new company, Freeport-McMoRan Oil & Gas Inc., with the ticker symbol FMOG. The market gave FCX a boost on the news. We will be evaluating the spin-off when it occurs, and advise whether to hold it or not.

After the spin-off, FCX will become a pure copper company again. Expanding economies around the world will be exerting increasing demand for copper. The stage is being set for another cyclical run in FCX.

**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 2013, NCR increased its debt load to make two significant purchases -- Retalix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth which caused the stock to slide and made it an attractive addition to the portfolio. These acquisitions pushed NCR much farther along its path from a hardware provider to a provider of software and services, where profit margins are substantially higher. Fourth quarter revenue reported in February was evidence that the acquisitions were beginning to prove beneficial.

Also bolstering growth is NCR's recent launch of its software platform, called Kalpana, which moves ATM software and operations to the cloud.

NCR is a value play. It is close to 10 times earnings which is a steep discount to the market. Its price to sales ratio is 0.8 compared to the industry average of 1.8. Its price to book

value ratio is 2.7 compared to the industry average of 6.0.

We have been recommending NCR because values like this often attract activists who make large investments and then try to unlock the value. On one day in mid-june, NCR jumped 13 percent on reports that the Blackstone Group LP and the Carlyle Group LP, the world's two largest private equity firms, have joined forces to outbid other buyout firms to acquire NCR in a \$10 billion leveraged buyout. It was also reported that NCR has been exploring options in recent months under pressure from shareholders. Marcato Capital Management has been calling on NCR to explore strategic alternatives and now holds a seat on its board of directors. We had previously reported that Jana Partners has acquired a 7 percent stake and the news confirmed our report.

It was also reported that other buyout firms are vying for NCR, including Apollo Global Management LLC, Thoma Bravo LLC, as well as other private equity firms. Some of these competing activists could also team up and bid against the Blackstone/Carlyle consortium.

So far, these reports have not been confirmed because these activists have been trying to keep their activities private. However, we see confirmation in a list that involves several large players with substantial activities, all concerning NCR, a company we have noted as deeply undervalued. We believe that the auctions for NCR have just begun, and are likely to continue

for several weeks. We recommend hanging on for the ride.

**Symantec (SYMC)** is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. 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.

By the end of the year, SYMC will spin off its relatively small storage business, Veritas, as a separate company which will allow both companies to be more competitive and responsive to their respective industries. Veritas will be operated as a separate company prior to the spin-off by October 3, 2015. The separation will make SYMC a more attractive acquisition to large information technology (IT) companies, with its strong balance sheet, along with its good



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Hersha Hospitality Trust	HT	NYSE	\$ 25.56	4.38%	\$ 31.20	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 15.58	3.85%	\$ 17.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.70	1.39%	\$ 34.00	BUY
<b>Vanguard REIT Index Fund</b>	<b>VGSIX</b>	<b>NYSE</b>	<b>\$ 24.81</b>	<b>1.45%</b>		<b>SELL</b>
Diversified Growth						
Agrium	AGU	NYSE	\$ 102.10	3.06%	\$ 110.00	BUY
Ford Motor Company	F	NYSE	\$ 15.02	3.33%	\$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 19.38	1.03%	\$ 24.00	BUY
NCR Corp	NCR	NYSE	\$ 30.12	0.00%	\$ 33.00	BUY
Pfizer	PFE	NYSE	\$ 33.59	3.10%	\$ 36.00	BUY
Stryker Corp.	SYK	NYSE	\$ 95.36	1.11%	\$ 98.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 25.46	1.10%	\$ 25.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 23.98	0.00%	\$ 27.00	BUY
Xerox	XRX	NYSE	\$ 10.78	2.32%	\$ 12.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 11.03	3.17%	\$ 15.00	BUY
Chevron	CVX	NYSE	\$ 96.69	4.43%	\$ 108.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 30.46	1.08%	\$ 34.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 13.64	0.66%	\$ 16.00	BUY
Transocean	RIG	NYSE	\$ 15.95	3.76%	\$ 19.00	BUY
Valero	VLO	NYSE	\$ 60.56	2.64%	\$ 65.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 17.81	0.00%	\$ 19.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 33.60	0.00%	\$ 38.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 26.10	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 49.30	0.00%	\$ 55.00	BUY
<b>S&amp;P 500 ProShares Ultra Short ETF</b>	<b>SDS</b>	<b>NYSE</b>	<b>\$ 21.12</b>	<b>0.00%</b>	<b>\$ 23.00</b>	<b>BUY</b>
Symantec	SYMC	NASDAQ	\$ 23.26	2.58%	\$ 27.00	BUY
Tekla Life Sciences Fund	HQL	NYSE	\$ 27.50	0.00%	\$ 30.00	BUY

**Notes to the table:**

Prices are as of 6/29/2015. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

cash flow and margins.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet including \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$1.9 billion in signed contracts to clean up military bases across the US. TTEK recently announced a two-year, \$200 million share repurchase program which will enhance earnings.

**Xerox (XRX)** has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The strongest growth is coming from the expansion

into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

XRX delivered strong profit and cash flow in 2014 with encouraging growth throughout the year, but had a disappointing first quarter. The stock has since been languishing in the \$11-12 range. The earnings short-fall was due to higher-than-expected startup costs for setting up some of the old legacy government health care accounts, which did not have allowances for such contingencies. However, this should not be a recurring problem.

The recent dip in the stock price puts it close to 11 times earnings, very cheap relative to the rest of the market.

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

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

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

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

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

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

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

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$12.3 million in stocks and to \$1.55 million in houses.

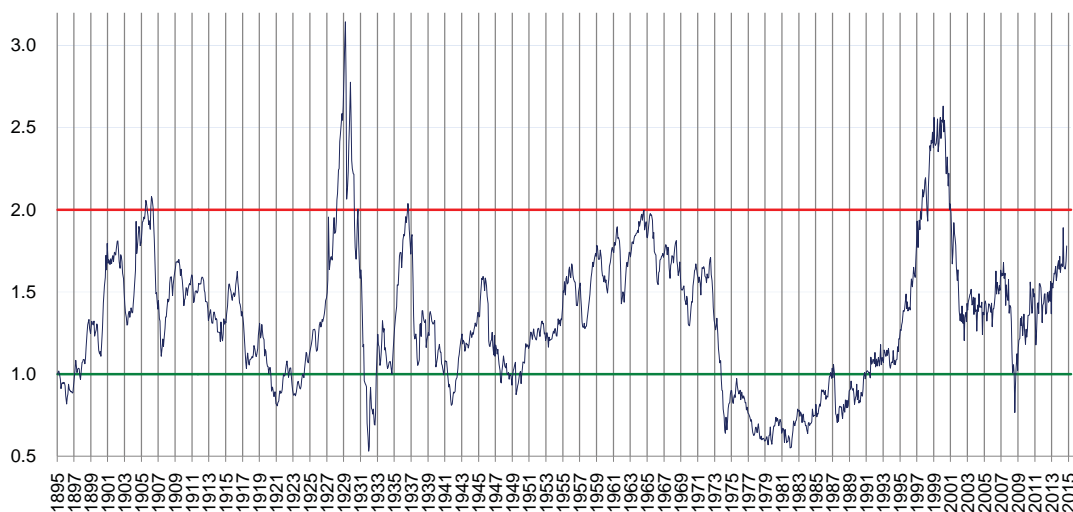
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$491 million, or 39.7 times more money—the 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 1.71. This reading reveals that stock prices are substantially above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

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



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

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

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

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

**However, the March 2015 signal has just been 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 most recent lagging economic indicators released in June (for May) causes the SoundAdvice Diffusion Index of Lagging indicators to hit 100 percent, giving us a new caution signal.**

### Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32 percent. During "Caution" signals, the S&P 500 increased an average of 2.8 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.0%		2.8%

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

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