Gray Cardiff's

SOUND ADVICE

Volume XX, Number 1 Subscription Rate: $195 per year January 19, 2007

2006 Was a Good Year...Now What?

2006 was a very good year for stocks. After a faltering first half, equities kicked up their heels in July and never looked back. For *Sound Advice* it was even better. As the chart below shows, our 19.6% total return outpointed the standard benchmarks. The portfolio was 3.8% ahead of the S&P 500.. That spread might seem piddling—what's 3.8%?—but if you can outperform the benchmark on a consistent basis, you have

Sound Advice Portfolio 2006 Performance: 19.6%Total Return

Holding	Return	Holding	Return
Agrium	43.5%	Molson Coors	16.5%
American Century Global Gold	26.6%	Newell Rubbermaid Inc.	27.0%
American International Group	6.0%	Perrigo Company	17.8%
Anglo American (bought 12/8/06)	1.3%	Phelps Dodge Corp.	78.3%
Asia Tigers Fund (sold 5/5/06)	36.1%	Plum Creek Timber	14.2%
AT&T	50.1%	Prudent Bear	5.9%
Coca-Cola Enterprises	7.8%	Royal Dutch	19.1%
Coeur d'Alene Mines Corp.	23.8%	Russell Corporation (sold 5/5/06)	37.2%
Comcast Corporation	63.3%	Safeway Inc.	47.0%
ConAgra Foods	37.1%	Sara Lee (includes sale of Hanesbrands)	-5.7%
Crescent Real Estate	9.1%	Schering-Plough Corp.	14.7%
CSX Corporation	38.1%	Senior Housing Properties	56.2%
Discovery Holdings	6.2%	Sony	5.8%
Dodge & Cox International Stock	24.6%	Stewart & Stevenson (sold 3/3/06)	64.5%
Electronic Data Systems	15.4%	Superior Industries	-10.6%
EnCana	2.5%	Symantec (bought 5/5/06)	17.4%
Excelsior Value & Restructuring Fund	13.8%	Telecom New Zealand (bought 8/3/06)	43.7%
Fidelity Japan	-6.4%	Tetra Tech	15.4%
Friedman Billings Ramsey (bought 2/3/06)	-25.8%	The New York Times Company	-4.7%
Gabelli Global Telecommunications	39.5%	The Walt Disney Company	43.0%
Getty Images (bought 9/8/06)	-5.7%	Third Ave.Small-Cap Value (sold 3/3/06)	4.0%
Honeywell International	24.5%	Third Ave. Value (bought 4/7/06)	0.8%
HRPT Properties Trust	29.5%	Time Warner Inc.	26.9%
ICON Energy Fund	8.4%	Transocean Inc.	16.1%
Johnson & Johnson (bought 3/3/06)	16.8%	United Parcel Service	1.8%
Liberty Capital	24.2%	Wal-Mart (bought 6/2/06)	-2.7%
Liberty Global (spunoff 5/15/06)	29.6%	Western Digital	9.9%
Liberty Media (ceased trading 5/15/06)	10.5%	WisdomTree Dividend 100 (bought 10/6/06)	5.6%
Mattel	47.3%	Xerox (bought 1/6/06)	15.8%
McDonald's	34.4%	Dow Industrials	16.3%
McKesson (sold 5/8/06)	-8.2%	S&P 500 Index	13.6%
Mitsubishi UFJ Financial	-8.30%	Nasdaq Composite	9.5%

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something. Try compounding that advantage over a decade, and you'll see what we mean.

And those performance numbers merely reflect equally weighted positions over the last 12 months. If you measure how our portfolio based on when and at what prices we bought and rebought these investments rather than the simple price change for equally weighted positions during 2006, the return is a whopping 33.3%.

What at the start of 2006 did we think would work? In the January 2006 issue, we highlighted five names that had disappointed during 2005, but believed held considerable promise: **Russell**, **Comcast**, **Disney**, **Sara Lee**, and **ConAgra**. Most at the time thought that food stocks, a clothing maker, a media/entertainment company and a cable provider were "dead money."

We also noted based on the market's first week or so of trading in 2006 that precious metals, energy, and Asia looked promising. But we felt no need to bulk up on these popular sectors, since we'd bought our positions at far cheaper prices in the past.

What worked? In the course of the year, our portfolio held 61 positions, of which nine were added, three were retired by acquisition, and two others were sold. We ended the year with 54 positions. Not surprisingly, most of the best performance came from positions recommended before 2006, since with value investing, time patiently invested alongside money are essential ingredients.

The two best performances were accelerated by takeover offers: **Phelps Dodge**, the copper miner, returned 78.3% after it had received a fat acquisition price. Ditto **Stewart & Stevenson**, the military vehicle manufacturer that returned 64.5%. **Russell Corp**., a clothing manufacturer, disappeared when Warren Buffet's Berkshire Hathaway took it private. It returned 37.2%. Other boffo performers were **Comcast** (+63.3%), **Senior Housing Properties** (+56.2%), **AT&T** (+50.1%), and **Mattel** (+47.3%).

As for the rest, **Disney** turned in a 43% performance, **ConAgra** 37.1%, and **Sara Lee**, which ended the year down 5.7%, in fact showed a modest 4.7% rise when we factor in the $2.75 a share we received when we liquidated the shares of **Hanesbrands** that SLE spunoff. Our quintet of "dead-money" names averaged 36.2%.

As for precious metals, energy, and Asia, they more than held their own, averaging an 18.3% total return, which is not to say that each did as well as hoped. Japan just didn't pan out. Only **Asia Tigers Fund** put in a superior performance, adding 36.1%. Though **Sony** fought back to a 5.8% rise, **Fidelity Japan Fund** and **Mitsubishi UFJ Financial** lost single digits.

The most pleasant surprise is **Telecom New Zealand**, recommended in August, which luckily coincided with a climactically terrible quarter that marked an abrupt bottom for the shares. They added 43.7%. We admit that for all our talk about value investing and patience, there's something to be said for quick.

Losers were limited. Nine lost ground. The worst performer was **Friedman Billings Ramsey,** which fell 25.8%. It's portfolio of mortgage-backed securities tumbled in value as the yield curve inverted. Not surprisingly, as the income-generating securities portfolio decayed, FBR slashed its distribution by 75%. FBR, which melds a financial services company with a mortgage REIT, needs to have a positive yield curve to profit from borrowing short and lending long. The only other double-digit loser (-10.6%) was **Superior Industries**, the wheel and rim manufacturer, that suffered along with its primary customers in the U.S.: GM, Ford and Chrysler. Both of these decliners showed signs of life as the year ended, and both are showing more life at the start of 2007. Perhaps it's just bottom-feeding by bargain hunters, but we're glad to see evidence that there are more buyers than sellers.

The lesson from 2006 is that even when you identify broad themes that do work, it's the sleepers that bring the best results. The broad themes such as metals did fine, but most of the biggest moves came from things like telecom, a fertilizer company, a couple of REITs (a sector that supposedly had exhausted its upside), and a supermarket chain. The lesson is simply this: buying stocks that are not merely down in price but which sport cheap valuations is the most rewarding method we know to make a profit. But it's not the most comfortable way to make a buck, since invariably such valuations are the result of being in an economically dormant sector, which is often compounded by inept management and bad business decisions. We humans are by nature more comfortable when we can be in sync with the herd. To make money our way, you have to move opposite the herd.

WHAT'S NEXT?

The year has begun with a somewhat confused market. Whatever supported the consensus that interest

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We've got a high school senior doing odd jobs around the office, and today he asked about Google. I said that I didn't know much about the stock, though I have loved the search engine ever since it first surfaced in the late 1990s. I told him that some analysts were projecting Google, currently trading around $500, would hit $650 in 2007—a 30% target—and that it seemed to have its finger in every hot pot on the Internet.

Should I buy a few shares, he asked. I try not to tell people what to do with their money when I don't have a dog in the fight. I did say that buying what is popular requires paying a premium. It's not that popular stocks won't make money, but you pay for the privilege. I told him, I prefer getting a discount.

Then I asked him whether at the start of 2006, had I offered him a gift of $1000 in Google shares or $1000 in Time Warner, which would he have taken? Trick question, he shrewdly said, and chose Time Warner.

Google in 2006 began the year at $420 and finished at $460, having traded as low as $337 in March and as high as $510 in November. For 2006, GOOG returned under 10%, about what the Nasdaq did but well behind the overall market. Time Warner was a different story, giving shareholders a 26.9% total return as investor opinion started to warm to TWX's value, especially to its rich cable network and its AOL division, which thanks to the success of Google and Yahoo! at milking advertising dollars from its sites, now is drawing interest for its advertising potential. Good luck with Google. We'll stick to the sticks in the mud.

--Gray Emerson Cardiff

Two For The Price of One

The last time we mentioned **Boston Scientific (BSX—NYSE)** was when recommending **Johnson & Johnson** for letting BSX acquire Guidant. But back in 2001, we loved BSX when it was scraping bottom, and enjoyed its robust resurgence (280% in 28 months). Our renewed appreciation now for Boston Scientific has its roots in Mr. Market's overblown expectations for the shares, and bloomed with its poorly conceived acquisition bid for Guidant that, unfortunately for Boston Scientific shareholders, succeeded. When that deal was announced, many Wall Street analysts cheered BSX's boldness. Now, it is being called perhaps the second worst acquisition story in American history. Pride of place still belongs to the **Time Warner-AOL** deal, which continues to be profitable for us, since we bought when consensus was still terrible. In Boston Scientific's case, negativity became received opinion. Given Wall Street's black-and-white mentality, the market can't help but miss the real value of what Boston Scientific acquired.

BOSTON SCIENTIFIC

Boston Scientific, when we recommended it in 2001, had pioneered stents, the metal scaffolding designed to prevent reblockage (restenosis) in blood vessels that through angioplasty had been cleared of obstructions. Nearly 80% of its sales derived from stents. Additionally, BSX designed, manufactured, and sold other devices for non-vascular minimally invasive surgery. In 2001, Boston was racing to bring a new type of stent, the so-called drug-eluting stent (DES) to market, but was in third place behind Johnson & Johnson, which would be first bring a DES to market, and Guidant, which was close to putting its version into physicians' hands. These stents, coated with drugs that reduced inflammation and the risk of restenosis (reblockage of the cleared vessel), were expected and turned out to be the next big thing.

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Sound Advice on Boston Scientific

When Boston Scientific convinced a federal court that Guidant in developing its DES had infringed on patents Boston Scientific controlled, BSX moved from a distant third into second place behind JNJ in the DES race. Johnson & Johnson itself was having problems meeting demand for its DES. When Boston Scientific's version was well received in Europe, BSX soared.

We got off the Boston rocket short of its zenith, after concluding that the sizzle exceeded the beef. Shares topped out in May 2004 shortly after BSX had put its DES version on the U.S. market and its shares had split 2:1. With Wall Street euphoric about BSX, a reversal in price seemed likely. What was surprising was how deep that decline would go.

BSX AND ACQUISITIONS

Boston Scientific historically has grown through acquisitions, adding smaller companies whose technology either overlapped its own, or offered extensions into related lines. By 2005, the boost from DES was slowing, and management recognized that by concentrating on minimally invasive devices aimed almost exclusively at vascular problems, the company had no springboard for future growth. In mid-October 2005, Boston Scientific warned it would not meet analyst expectations either for the current quarter or the year. One problem was the costs associated with launch of its DES, and another was competition with JNJ. The answer was to make an acquisition, and a very big one: Guidant.

Guidant was a major manufacturer of cardiovascular-related devices, specializing in implanted monitors to manage irregular heart rhythms, and, in a crisis, to shock a heart back to life. Guidant in that sector was second only to Medtronic.

Guidant also owned some unique technologies for its new coated stents, which could benefit Boston Scientific's own products. Admittedly, Guidant's cardiac rhythm device plants had suffered some serious manufacturing and design problems, but Boston Scientific believed it understood their extent. Getting Guidant promised immediate diversification for narrow BSX.

The problem was that Johnson & Johnson at the end of 2004 had already offered $25.4 billion ($76 a share) for the company. But in May 2005, just after Guidant's board had accepted JNJ's offer, Guidant announced 26 failures of its implanted defibrillators. One failure resulted in death. Then the New York Times reported that Guidant had known for years about the potential problem, but failed to notify the medical community.

Guidant eventually had to recall more than half the defibrillators it had manufactured. Johnson & Johnson renegotiated its price down to $21.5 billion ($63 a share), which Guidant's board accepted.

Boston Scientific saw its chance, offering $72 a share. JNJ countered. Boston offered $80 a share ($27.2 billion): half in cash, half in shares, a price JNJ wisely refused even to match. Boston also paid JNJ $705 million for forcing termination of its deal. Abbott Laboratories assisted Boston by ponying up $1.4 billion to buy newly issued BSX shares and promised to pay $4.1 billion for Guidant's stent (both bare and drug-eluting) businesses after the acquisition was consummated.

The deal closed on April 21, 2006. At that point, Boston Scientific shares already had declined 19% from $27.33, before it lunged for Guidant (BSX had topped out in May 2004 at $45.81). To cinch the deal, BSX had added goodies. For example, BSX pledged to issue more shares should its own share price decline before the deal closed. That pledge resulted in the issuance of 16% more dilutive shares.

If Guidant shareholders had reason to rejoice, shareholders at Abbott Labs, which played Boston brilliantly, were ecstatic. They acquired not just Guidant's non-invasive surgery assets but also grabbed its innovative drug-eluting stent technology. Boston Scientific was so intent on grabbing Guidant that they sacrificed one of Guidant's gems to reach that goal. They paid more for less.

MORE PROBLEMS

It wasn't just Guidant that was having problems with the FDA. As

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details of the acquisition were being finalized, federal regulators warned Boston Scientific that it had serious production problems at three of its own facilities. In addition, the FDA chided Boston Scientific about inadequate responses to earlier complaints, and warned that any failure to satisfy FDA inspectors could result in the FDA blocking introduction of new products from those plants.

Boston Scientific also is busy in various courts arguing as defendant and plaintiff over patents with JNJ, and others. Then there are the consumer suits stemming from Guidant's recalled devices.

What BSX management had thought would give the company and its shares a boost for the moment had turned into a lead balloon. Furthermore, the outcomes and potential costs of law suits stemming from not only consumers over product issues but from competitors over patents are not easily quantified. As is always the case on Wall Street, analysts tend to presume outcomes ranging from very negative to catastrophic. Almost invariably, they overstate the potential damage.

Finally, Medicare and Medicaid, the primary insurers for Boomers as they enter their 60s, are intent on reining in costs, and keep on trimming what they pay for procedures and medical devices. Certainly, pressure from government and other insurers to push prices lower is a concern, but we think that Boston Scientific (and for that matter, all healthcare providers) can continue to make good profits on existing technologies, and can harvest bumper profits from new products as Boston Scientific and others did from DES. Though insurers, both government and private, will continue to apply pressure, the noise, we think, will be more loud than painful.

A glance at last quarter's (Q3) 10Q illustrates Boston Scientific's current circumstances. Sacrifice of Guidant's proprietary DES technology to Abbott Labs and the likelihood that Abbott will license it to others has accelerated competition. Not surprisingly, one reason for BSX's disappointing 3Q results is smaller stent sales at lower prices. Noticeable declines occurred both in the U.S. and internationally as new competitors emerged and physicians became less certain that DES had entirely supplanted uncoated stents.

Boston Scientific is now on sale. Currently, using the trailing four quarters for our calculations, we find Mr. Market thinks as poorly of Boston Scientific's sales, earnings, cash flow, and book value, as he has at their respective average annual bottoms.

The costs of integrating Guidant technology and personnel and the almost four-fold jump in financing the debt used to acquire Guidant created a loss of $3.19 per share for the first three quarters of 2006. When the Q3 numbers were published, BSX lurched to a four-year low at $14.65.

IF BSX IS IN ICU, WHY BUY?

Everyone recognizes that demographics favor all aspects of healthcare. That great population bulge, the Baby Boomers, are now crossing into their 60s, which means demand for medical care, much of it high end, will be a rallying cry for this most demanding of generations. We're not just graying as a people. We also are hanging around longer. In 2000, about 9.3% of the U.S. population was aged 80 or older. By mid-century, that percentage will have more than doubled.

Furthermore, America is the only first-world society not to offer universal healthcare. We can argue all we want about the quality of universal healthcare in Canada and elsewhere, but at some point the United States will join our peer economies to insure the entire population. Many of our fellow citizens who just suffered with not just arthritis but with life-threatening illnesses will become medical care consumers, a huge tide. This augurs well for Boston Scientific. At that point—and perhaps sooner—government will become more active in setting costs and negotiating discounts. But this won't cripple companies like BSX.

Outside the U.S., demand for what Boston Scientific makes is also ahead. Heart and vascular disease are the most common cause of death in the United States and other mature economies. As other nations get globalized, their medical problems will more and more resemble those we know here in the U.S. Demand for what Boston Scientific does is deep and wide.

We also believe that Boston Scientific will resolve its production and regulatory problems. Those who wait for some "catalyst" to become apparent before they invest lose much of the surge in prices that occurs before and just after whatever initiative emerges to escape to correct existing problems.

Our starting point is that companies with well-established products, solid reasons for future growth, reasonable balance sheets, and competent management eventually will find that path. Boston Scientific fits these measures, though, we concede, that the same management that we expect to figure out how to

restore a steady pulse to this company are also responsible for overreaching in the Guidant acquisition.

But it is ownership of damaged Guidant that for us cinches the argument for owning Boston Scientific. We can get "two for the price of one." On the day before Boston Scientific made its first bid for Guidant, the stent-maker's market cap stood at around $23 billion, and it had long-term debt of $2.4 billion. The next day, when Boston Scientific went public with its price, Jim Tobin, the CEO, defended what most considered an upstart offer, saying that a combined Guidant-Boston Scientific would be "greater than the sum of its parts."

Tobin's arithmetic was premature. In terms of market capitalization, the combined companies today are valued at about $5 billion more than Boston Scientific was the day Tobin did his sums. Looked at another way, Boston Scientific's current $26.8 market capitalization is about what it paid for Guidant.

If you calculate Boston Scientific's enterprise value (market cap plus debt minus cash), today's Boston Scientific is about a third less than where it stood in December before entering the bidding war for Guidant plus what it paid for Guidant. We willingly note that Boston Scientific overpaid for Guidant, but we judge it absurd that the two companies combined are worth little more than either Boston Scientific paid for it or Boston Scientific alone was worth. BSX shareholders in 2005 are the real losers. At this point, we think, new buyers can be the real winners.

SOME NUMBERS

We always like to see companies scraping bottom on their price ratios, and Boston Scientific after its steep fall from grace meets those low standards. Some market mavens simply look for low ratios compared to the overall market, but for us that is too blunt an instrument. We think it is always better to consider a particular company's stock valuation history as a marker for truly low valuations.

Boston Scientific is now on sale. Currently, using the trailing four quarters for our calculations, we find Mr. Market thinks as poorly of Boston Scientific's sales, earnings, cash flow, and book value, as he has at their respective average annual bottoms. BSX lately has been trading at a price to sales ratio of 3.3 (average historical low going back to 1991 has been 3.2), price to cash flow ratio of 13 (average historical low is 14.8), price to earnings of 15.4 (average historical low is 19.4), and price to book value of 5.5 (average historical low of 6.6). If we look at comparable firms, the current trailing price ratios all point to BSX's relative value.

Admittedly, the balance sheet is now groaning under debt assumed to make the Guidant deal. In fact, it has almost quadrupled to $8.9 billion. Management will use cash flow to reduce that burden.

We expect Boston Scientific can right itself, get the assets Guidant possessed to function efficiently, continue to add new products, and defend its current stable of products, especially its stent business. There are plenty of opportunities internationally, and, if our expectations about a shrinking dollar are correct, those sales will be enhanced when translated back into a weaker dollar. Certainly demographics favor what Boston Scientific provides.

We think that Boston Scientific's shareholders already have paid the price for management's missteps. With shares in the ICU, it's not a bad time to prepare for Boston Scientific regaining its rhythm.

IS GUIDANT GETTING IT TOGETHER?

We got the first inkling that maybe Boston Scientific has started to get things right in a January 8th press release from Jim Tobin, BSX's President and CEO: the Guidant division will shrink not just to save money but to trim away less productive projects. The company will downsize by 500 to 600 employees (BSX employs about 29,000 worldwide), almost all from Guidant. Tobin says BSX will direct savings to reinvigorate the pipeline of new products, and will put in place new expense controls, because apparently Guidant was undisciplined in its spending. More importantly, Tobin also announced preliminary sales for its cardiac rhythm device division rose 10% to $489 million and defibrillator sales had risen by 13% to $356 million.

An analyst or two upped the price target, but, good for us, kept their ratings at Hold. Investors, too, liked Tobin's tone and message. BSX is up 13% since we began to prepare this recommendation in early December.

Here at *Sound Advice*, his announcement was met with "Couldn't he have waited another couple of weeks to say something positive?" Whether this is just a nice flurry of interest that preexisting pessimism will overwhelm remains to be determined. We're confident about Boston Scientific's eventual recovery, and think that effectively paying $5 billion for what BSX paid $29 billion, even with Guidant's problems, is a proposition we will happily (and anyone one else would) take up. Buy BSX up to $20. ***SA***

PORTFOLIO UPDATES

Wall Street has been selling off almost all commodities. We've seen this before, especially after energy and other natural resource stocks hit their highs in early May 2006. Explanations for why each commodity is faltering differ in some ways and are similar in others. Energy, for example, is being buffeted by an unseasonably warm winter throughout much of North America and elsewhere around the globe, and by concerns that a slowing U.S. economy will burn less fuel and need less oil-based products. For the moment, no geopolitical flash point for energy supplies is in the news, though no one seems to be noting how precarious things are getting in the Persian Gulf. Copper and other base metals are dropping because the housing sector in the U.S., a voracious consumer, is on a diet, and there are concerns that emerging economies, especially China, cannot keep devouring metals. The common forces impacting all hard assets are a dollar that has reversed direction and is strengthening and the quick retreat from commodities of speculative money.

In the past, we've argued that which way the thermometer happens to be pointing is not too important for us, since weather invariably reverts to form. Unseasonable weather eventually balances out. However, we do recognize the effect of a two-by-four applied to our head, and the impact on our energy positions hurts. As for metals, we see no evidence that China has satisfied its needs. Indeed, as China struggles to become a modern economy and society, infrastructure needs can only accelerate. The impact of the 2008 Olympics just magnifies the urgency. Dollar strength, we believe, is just fooling us, and might be responding to growing recognition that the Fed is not going to cut rates, which makes the dollar less worrisome to hold. However, factors other than where short-term interest rates are heading are more decisive and more troubling for the dollar. We think metals, both industrial and precious, still have a strong future. We remain bullish, if chastened, about commodities.

The Dow since December 8th, when we closed our books for the December issue, is up 2%, the S&P 1.5%, and the Nasdaq 2.8%. The *Sound Advice* portfolio on a total return basis is up 2.2%. Commodities held us down, but we'd be ingrates and, more importantly, wrong to dump them now.

Anglo American, the December letter's recommendation, is up by a smidge since its 12/8 recommendation but down 0.9% for the first two weeks of 2007. AAUK has its oar in nearly every commodity, especially coal, ferrous metals, and gold. Anglo American looks more to Asia and Europe for its sales than to the U.S., and thus even if demand from North America does slip, AAUK has its biggest customers elsewhere.

American Century Global Gold Fund dropped 9.5%/9% (since the last letter/since start of 2007) in response to a stronger dollar. **Coeur d'Alene**, the most volatile of our commodity positions, dropped 16.9%/12.7%.

At least when it comes to commodities, especially metals and energy, we vote that the U.S. no longer is the decider, though slowing here will color the global market. We've tried to factor that drop off into our expectations, but still find the for-the-present bottomless appetite for the hard stuff among the Chinese, Indians, and other emerging economies enough to keep pressure on current supplies.

For example, China has contracted with a Brazilian supplier for iron ore at prices almost 10% above the 2006 price. Also, China has bought for $1.9 billion a Canadian energy company's assets in Kazakhstan, just another pool of oil and natural gas to keep China humming, a deal reminiscent of transactions between Chinese interests and Anglo American. China prefers to own the cow rather than just buy the milk.

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With energy prices dropping like a rock, and with media opinion on energy prices' direction uniformly pessimistic, there are few hard facts to support that view except that prices are falling. The Chinese-in-Kazakhstan story is one. Here is another: **Transocean** has more business than it knows what to do with. You read about Chevron's announcement of an elephant field in the Gulf of Mexico a few months ago. But Chevron knew the gas was there years ago, but did not consider it feasible at then current energy prices to develop the field. Now, with natural gas triple where it was just a few years ago—even after tumbling from highs hit post-Katrina—it is economically and technically feasible, but there are not enough rigs to handle the work. Currently there are 18 rigs in the world capable of tapping this field, and Transocean owns most of them. Now day rates run about $520,000 a day for the Cajun Express, the Transocean rig Chevron is using in the Gulf, and it's expected to reach $1,000,000 a day by mid-2008. At that time, more rigs should be rolling out of shipyards, and that will have an impact on day rates. For the moment, Transocean is in the catbird's seat, and even with more rigs in the mix, can expect to reap premium day rates for its efforts. For example, Chevron has pre-leased two rigs currently being built for Transocean. They will be floated into position when finished in 2010. They cost for them is estimated to be $1.5 billion.

We're aware that concerns over a slowing global economy are impacting prices for energy companies, since lighter demand translates into lower prices. However, demand will pick up, and whether demand is lighter or heavier, the problems facing Chevron translate into higher costs for energy relative to where those prices would be were there not an infrastructure bottleneck. One other consideration: even if more rigs are being built, the looming question as to whether global energy production has peaked just as it peaked in the U.S. should be on investors' minds. Natural gas fields in the Gulf of Mexico are declining at a 30% rate. Saudi Arabia, despite its protests, also seems to be finding it harder to push production higher. The most promising energy sources seem more and more to be in locales that are less and less safe either from geopolitical instability or from their inaccessibility. None of this makes us think energy is going to get cheap soon.

All of this is reassuring about why RIG retains a positive outlook. However, **Transocean** is off 8% since the last letter, all of the damage coming this year (-9%).

Outcomes for other energy positions were no better. Since the last letter and since the start of 2007, **Royal Dutch** is off 5.6%/5.7%. **Icon Energy Fund**, which made a $3.36 distribution last month, dropped 10.3%/7.8%, and **EnCana** led the retreat, down 14.4%/1.6%. We do not believe that current prices for energy stocks fairly reflects their value. We're not sellers, and, for those who are light on energy in your portfolio, recommend judicious buying. ECA and RIG seem particularly attractive.

The only pure commodity position to prosper was **Plum Creek Timber** up 6.5% since the last letter, but off a few cents this year. That superior performance continues a trend that started in early October. PCL had lagged other commodities during 2006, and challenges the assumption that copper and other metals used in housing construction are doomed, since lumber is just as important in home building.

As we note in the cover story, though commodities did well for us last year, they only explain part of the portfolio's success in 2006. The same applies to the start of 2007. We got excellent performance from a grab bag of positions: **Senior Housing Properties** added 16% on no news. Other REITs in the senior housing/medical care sector are doing well but not as well as SNH, which makes us wonder if someone is sniffing around this REIT. **Sony** added 14.5% as consumers snap up not just its newest gaming system, the P3 but also the P2. **Liberty Capital**, which benefited from the deal to swap Liberty's 29% position in Murdoch's News Corp. for 38% of DirecTV, the satellite TV company plus other interests and cash, is up 12.4%/5.1%. The other two positions thrown off by Liberty Media are also booming: **Discovery Holdings**, added 5.6%/4.4% and **Liberty Global** 7.7%/4.3%. Indeed, media stocks in general are on a tear: **Comcast** is up 2.1%/1.6%, **Time Warner** 8.2%/3.2%, and **Disney** 2.4%/1.8%. **Schering-Plough** is moving toward the mid-20s, adding 6.2%/2%.

Even **Friedman, Billings, Ramsey**, a disappointment in 2006, has rebounded 9.9%/3.8%. Whether it's a bounce of the "deadcat" variety or the start of a sustainable recovery remains to be seen.

Symantec, Molson Coors, Telecom New Zealand, Mattel, ConAgra—none that got or gets much mention from the financial media and that reflect no particular "trend"—all did well since the December letter. Some newsletters make occasional outsized results by going "all-in" on hot trends such as energy. We don't work that way. We're eclectic, to say the least, and thus diversified. The heart of *Sound Advice* remains ferreting out value wherever it might be found. ***SA***

Sound Advice Portfolio for January 2007

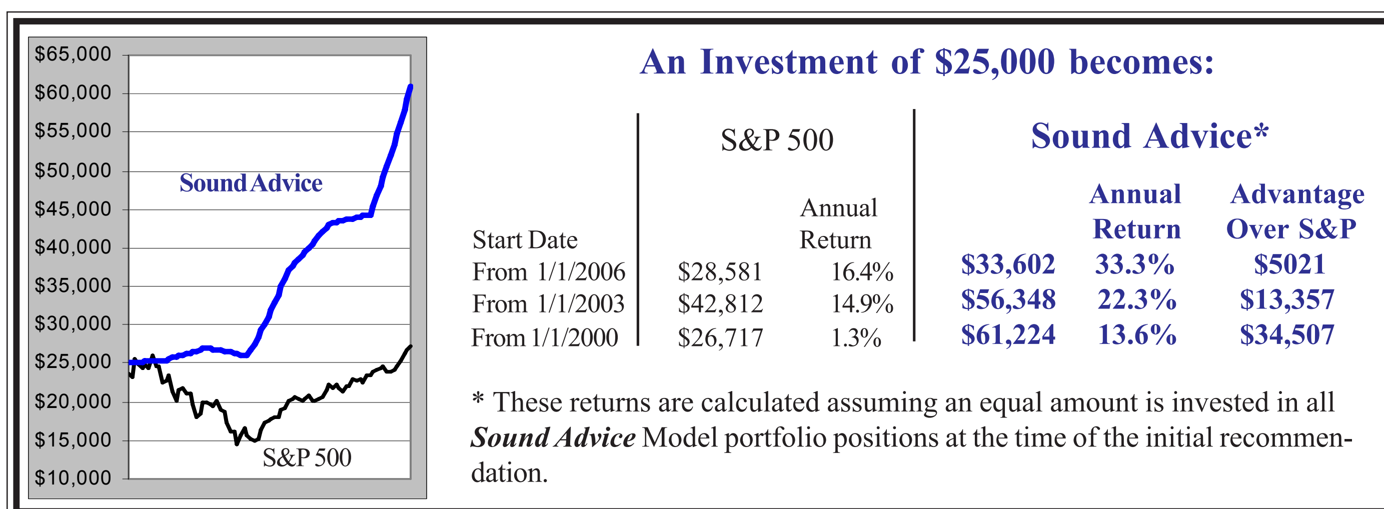
Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	$12.65	6.64%	**$13.25**	BUY
Senior Housing Properties	SNH	NYSE	$25.76	5.28%	**$27.00**	BUY
Diversified Growth					.	
Agrium	AGU	NYSE/TSE	$33.14	0.33%	**$36.00**	BUY
American International	AIG	NYSE	$71.07	0.70%	**$75.00**	BUY
AT&T	T	NYSE	$34.73	4.09%	$38.00	BUY
Boston Scientific	**BSX**	**NYSE**	**$18.21**	**0.00%**	**$20.00**	**BUY**
Coca-Cola Enterprises	CCE	NYSE	$21.02	1.14%	$24.00	BUY
ConAgra	CAG	NYSE	$27.05	2.66%	**$29.00**	BUY
CSX Corporation	CSX	NYSE	$34.70	1.15%	$40.00	BUY
Disney	DIS	NYSE	$35.21	0.88%	$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	$43.55	1.31%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	$52.58	0.91%	N/A	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	$16.64	0.00%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	$22.78	0.61%	N/A	BUY
Getty Images	GYI	GYI	$44.34	0.00%	$49.00	BUY
Honeywell	HON	NYSE	$45.56	1.99%	**$50.00**	BUY
Johnson & Johnson	JNJ	NYSE	$66.64	2.25%	$69.00	BUY
Liberty Capital	LCAPA	NASDAQ	$101.37	0.00%	**$110.00**	BUY
Mattel	MAT	NYSE	$23.36	2.78%	**$25.00**	BUY
McDonald's	MCD	NYSE	$44.22	0.52%	$47.00	BUY
Molson Coors Brewing	TAP	NYSE	$76.86	1.07%	**$81.00**	BUY
Newell Rubbermaid	NWL	NYSE	$29.67	2.83%	$31.00	BUY
New York Times Co.	NYT	NYSE	$24.05	2.91%	$27.00	BUY
Perrigo	PRGO	NASDAQ	$16.70	1.08%	$20.00	BUY
Safeway	SWY	NYSE	$33.79	0.69%	**$38.00**	BUY
Sara Lee	SLE	NYSE	$16.93	2.36%	$18.00	BUY
Schering-Plough	SGP	NYSE	$24.37	0.90%	**$28.00**	BUY
Sony	SNE	NYSE	$47.68	0.45%	**$50.00**	BUY
Superior Industries	SUP	NYSE	$19.90	3.22%	$23.00	BUY
Telecom New Zealand	NZT	NYSE	$27.26	8.20%	**$29.00**	BUY
Tetra Tech	TTEK	NASDAQ	$17.83	0.00%	$20.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	$60.15	5.55%	N/A	BUY
United Parcel	UPS	NYSE	$74.44	2.04%	$82.00	BUY
Wal-Mart Stores	WMT	NYSE	$47.98	1.40%	$52.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	$58.21	3.16%	N/A	BUY
Xerox	XRX	NYSE	$17.01	0.00%	$18.00	BUY
Energy/Natural Resources						
American Cent. Gold Fund	BGEIX	800-826-8323	$18.51	0.27%	N/A	BUY
Anglo American PLC	AAUK	NASDAQ	$24.00	1.81%	$29.00	BUY
Coeur d'Alene	CDE	NYSE	$4.45	0.00%	$5.50	BUY
EnCana	ECA	NYSE/TSE	$46.15	1.30%	$52.00	BUY
Icon Energy Fund	ICENX	800-764-0442	$29.80	11.28%	N/A	BUY
Plum Creek Timber	PCL	NYSE	$39.60	4.04%	$41.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	$67.81	3.61%	**$74.00**	BUY
Transocean	RIG	NYSE	$74.67	0.00%	**$82.00**	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	$44.09	0.00%	**$45.00**	BUY
Crescent Real Estate	CEI	NYSE	$19.94	7.52%	$22.50	BUY
Discovery Holdings	DISCA	Nasdaq	$16.90	0.00%	$17.00	BUY
Electronic Data Systems	EDS	NYSE	$26.85	0.74%	$30.00	BUY
Friedman, Billings, Ramsey	FBR	NYSE	$8.27	2.42%	$9.00	BUY
Liberty Global	LBTYA	NASDAQ	$30.76	0.00%	$29.00	BUY
Mitsubishi UFJ Financial	MTU	NYSE	$12.64	0.75%	$16.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	$5.62	1.78%	N/A	BUY
Time Warner	TWX	NYSE	$22.73	0.97%	$22.00	BUY
Symantec	SYMC	NASDAQ	$20.48	0.00%	$25.00	BUY
Western Digital	WDC	NYSE	$21.04	0.00%	$20.00	BUY

Prices as of the market close on Friday, January 12, 2007
****Yield represents all distributions during current calendar year divided by share price.***

BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT

Sound Advice Indicators & Performance for January 2007

Performance History: Sound Advice versus the S&P 500



An Investment of $25,000 becomes:

Start Date	S&P 500	S&P 500 Annual Return	Sound Advice*	Sound Advice Annual Return	Advantage Over S&P
From 1/1/2006	$28,581	16.4%	**$33,602**	**33.3%**	**$5021**
From 1/1/2003	$42,812	14.9%	**$56,348**	**22.3%**	**$13,357**
From 1/1/2000	$26,717	1.3%	**$61,224**	**13.6%**	**$34,507**

* These returns are calculated assuming an equal amount is invested in all ***Sound Advice*** Model portfolio positions at the time of the initial recommendation.

The Sound Advice Market Indicators:

The Diffusion Index of Leading Indicators gives "buy" signals when all five of its leading economic indicators drop below their respective levels of six months earlier. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates. **Currently, 40% of its leading indicators are above their levels of six months earlier.**

The Diffusion Index of Lagging Indicators gives "sell" signals when all five of its lagging economic indicators rise above their respective levels of six months earlier. This reveals a strengthening economy and inflationary pressures ahead. Currently**, 75% of its lagging indicators are above their levels of six months earlier.**

While we recommend remaining fully invested in the ***Sound Advice*** model portfolio at all times, we use the ***Sound Advice*** Market Indicators to influence our approach and nature of our recommendations. When "sell" signals are in force, our recommendations are defensive in nature and we are likely to recommend taking profits more readily. Conversely, during "buy" signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistantly outperform the market.

The latest signal came from the Diffusion Index of Lagging Indicators, a 100% reading in October, which constitutes a "sell" signal.

History of the Signals

* 2003 **In March, just before the surge in the market, the indicators gave a buy signal. The S&P 500 advanced more than 40%.**

* 2000 **In May, close to the peak of the market, the indicators signaled the end of the bull market. The market subsequently dropped 40%.**

* 1995 **In March, the indicators gave a sell signal. Then in July, the gave a buy signal. The S&P rose 153% until the next sell signal in May 2000.**

* 1988 **In January, the indicators signaled the subsequent bull market that took stock prices up 95% until the next signal.**

* 1987 **Six weeks before the 1987 Crash, the indicators gave a sell signal.**

* 1981 **A buy signal occurred close to the beginning of the next bull market that carried stock prices up 145%.**

* 1980 **A sell signal warned of that year's bear market.**

* 1974 **With the Dow Jones trading below 700, the indicators issued a buy signal, announcing a 6-year bull market.**

* 1973 **They signaled a "sell" just prior to the bear market that cut stock prices in half by October 1974.**

* 1970 **The indicators signaled the beginning of the new bull market.**

*** 1968 At the zenith of the huge bull market of the 1960s, the indicators gave a sell signal before a 25% decline.**

(...continued from inside front cover...)
rates were heading lower has come into question. Is the economy stronger than everyone thought? Can the dollar continue to defy economic gravity and not fall further? Is the collapse in energy to continue, or is it just a fake lull before we go back to the $60s and $70s? What about metals, industrial and precious both? Lately, they are reversing their 2006 trends.

We're still committed to higher commodity prices for reasons we explain in the Updates section (pages 7-8). And the dollar still has the piper to pay for our trade and fiscal distortions. Demand for energy and other commodities, even if the U.S. cannot maintain its growth rate of the past three years, remains robust elsewhere around the globe. Though we recognize that so far we have had an ultra-mild winter throughout most of the United States. Suddenly, every one is a weatherman with only one prediction: Warm and Mild. We're hardly weathermen, but we do know that when everyone thinks one way, it's time to consider the alternative.

Grand ideas and global perspectives are fine and good, and we'll monitor how these macro ideas play out. But our main concern will be to ferret out cheap stocks without concern for any grand market theme.

That approach has made market-beating returns for our subscribers. If your issue carries an alert that your subscription is about to lapse, take advantage of the deals described below to continue receiving *Sound Advice*. ***SA***

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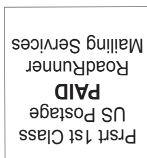

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