

What We Are Doing Now



Last week, Steve Horwitz, our managing editor, mentioned that friends who had been asking him for investing advice for the last few months had told their advisor to sell everything and put them in cash. No, Steve is not giving friends one market view (Sell!) while we're advising subscribers to Sound Advice to do just the opposite (there's a broker story about that, but I'll save it for a less somber market moment). The couple, a psychologist and an executive in a publicly traded medical technology company, are nearing retirement. They looked at the stressed U.S. economy and its dysfunctional political leadership, saw the value of their assets eroding, mindful of how expensive the 2008 crash had been, realized they had no compass to navigate the market and quietly declared they couldn't take it anymore. In a way, I am envious, since the last few weeks have not been fun. Not only am I losing my own money but I'm losing money for those who rely on our advice. We'd all be better off for the moment had we gone to cash when this couple did.

However, that is not how this works, since we are not investing "for the moment.". Though we are certainly not back to where our portfolio stood in early March 2009, investors seem just as dispirited now. You might recall our writing about a subscriber letter we received that was written on the very weekend the market bottomed. The writer, thoroughly disillusioned and impoverished by the bear market, told me he had sold everything in his portfolio: stocks, bonds, funds and gone to cash. In retrospect, of course, he could not have chosen a worse moment to act so decisively. Even after this year's performance, the benchmarks are anywhere from the Nasdaq's 99% to the Dow's 75% higher than where they were the day I received his letter of surrender. What can convince an investor who abandons the market when he no longer can tolerate losses to buy back into that market? What it often requires is his inability to tolerate watching the market rise—unfortunately that often coincides with a market that has run its course.

Sound Advice has its buy and sell signals (really they are signals to be more aggressive or more defensive), but we are always 100% invested, a relatively rare approach in the newsletter world. Ultimately it's a concession that total in-and-out market timing rarely gets it right. Because we want to be aggressive when the economy is weak, we are ready to buy now.

-Gray Emerson Cardiff

Pricing each issue on Friday has its drawbacks. Regardless of what happens as we finish the editorial process, we can never substitute Monday's or Tuesday's prices as our baseline, but occasionally—such as after the S&P downgrade—we must reshape our comments. The downgrading of U.S. debt in itself is not the problem. Treasury can pony up money to meet our obligations. Instead, it is a naked-emperor moment when an outside observer applies a quantitative and qualitative measure to the United States fiscal situation and declares it untenable. Washington had a chance for a grand bargain with both heavy budget cuts and relatively modest revenue increases and failed, so S&P pounced. But that is not why the markets cascaded lower. Rather, share prices are shouting that economies in the U.S. and Europe are entering a new recession and equities need to be repriced to reflect that despite corporate earnings that have been good, and in some cases great. Yet when we look at the general economy, except for the better-than-expected (but still feeble) jobs report last week, there's been no positive news for more than a month. Is there a difference between an economy in recession or one that is "growing" so slowly that you need to hold a mirror up to its mouth to make sure it's still breathing?

So what do we do as investors? At these free-fall moments, veteran brokers try to keep their clients from panicking. Some show skittish clients charts that track the market over decades and are marked to show what at the time were considered market devastating events such as the start of World War II, the assassination of JFK, the October 1987 market panic or the post-9/11 market meltdown but in retrospect were merely blips in a long march to higher prices. The same argument is being offered in the media (between breathless reports about plummeting share prices). Some aggressive ones quote Buffett ("Be fearful when others are greedy, and be greedy when others are fearful.") or Baron Rothschild ("Sell at the sound of trumpets and buy at the sound of cannon."). But that's too abstract, too removed from the immediate pain and fear anyone suffers in such a market. Instead, here is the best comment about investing at moments like these but it's almost always abbreviated. Again it was Rothschild, whose advice "to buy when blood is running in the street" is a standard in the contrarian's book of familiar quotations but fails to include the crucial final words that personalize it: "even when it is your own."

The upside of this lag between pricing and publishing is that, after today's events, you get to evaluate our ideas at a steep discount. On the next page begin three recommendations that as of last Friday were down for the year: 24% (CWH), 12.4% (PAYX) and 21.2% (RIG). In Monday's panic, they lost 12.6%, 5% and 10.1%, half again what they had lost through Friday. As companies, nothing changed for them today except investor fears about what a severe recession would do to them. We believe those fears are exaggerated, which happens when the market fixates on its fears. Balance sheets for each show debt ranging from satisfactory (CWH) to non-existent (PAYX). Each pays a substantial dividend that in the case of CWH is now extreme. If you have been with *Sound Advice* for a while, you have seen how investing against the background of a weak economy works. It's up to you. **SA**



Yield Now, Growth Later

When the market drops abruptly, our first instinct is to look at opportunities within our existing positions. Over the last month, we'd been researching a fresh recommendation related to housing, which we still think is worth including in the Sound Advice portfolio, but right now we prefer to concentrate on a trio stocks you are probably familiar with.

We've had a classic correction, which as of this Monday verge on a bear market. Equity markets are now down from their highs of late April and the free fall that occurred Thursday before last unnerved the market. Now Wall Streeters are hiding under their beds, fearful about what a return to recession would mean for revenues, earnings and share prices, and they've been unloading shares without regard to fundamentals. In truth, if we do get a significant slowing in the economy, today's sellers for a time will feel great. Over the longer-term, however, they won't.

But we can understand Mr. Market's apprehension. After the previous decade that featured two bear markets and inexplicable share price movements such as the flash crash, most investors prefer to sell now and think about why later. For professional investors whose reputations depend on not just quarter to quarter performance but even what they did yesterday, keeping in tune with today's music is probably essential. For us, whose only measure of success is how much our portfolio is worth in the long run, market anxiety creates opportunities.

The three stocks we re-recommend below are all cyclical. Each pays a significant dividend thanks to the damage their shares have suffered lately and each, we believe, will trade substantially higher once our economy regains its stability. We know that such a notion makes people laugh. Personally we worry about where the economy is, are dismayed by the miserable job numbers and disgusted with the state of national leadership, but we also have been here before and were buyers. We cannot do differently now. We hope the following recommendations lead you to do the same.

Paychex (PAYX—Nasdaq) came into the portfolio last October at pretty much its current price. As has been the case for almost every recommendation we have made over the last year, it required us to take the other side of the recovery wager: if the U.S. economy can't regain its traction, a company that makes its money from managing payroll and human resource needs for small to medium firms, will remain stagnant. We were (and are) willing to take the other side of this bet. For the first few months, PAYX flourished. As confidence grew that the U.S. economy was ready to return to normal growth, Paychex was propelled, reaching \$33.47 in early March, just before pessimism began to seep back into GDP predictions.

As discouraging report followed discouraging report, the shares have returned to where we began. So let us repeat the question we posed back in October as to why Paychex was so cheap: "Any idiot could answer that: the most corrosive aspect of this recovery from recession is the lack of job creation.

Fewer jobs means fewer employers either needing to expand or even requiring payroll services. Unemployment is running at just under 10% and if you factor in those who have stopped looking for work, those that are not working as many hours as they need and those who can find only low-paying jobs, the real underemployment figure would be double the official number. CEOs are sitting on their hands, unsure about whether dispirited consumers need or want what expanded production would bring to market. Corporations are just as indecisive and anxious about the future as the rest of us and are unwilling to expand. In this environment, why own shares in a company that is a proxy for employment levels? From our perspective, what better time could there be to buy them?"

Since the initial recommendation, Paychex has increased revenues faster than operating costs, thus boosting earnings. There's been a change in leadership and the company has spent to fix problems in its sales force. It's also addressed the challenge coming from Internet-based, low cost competitors that appeal to very young, very small firms. The solution has been to buy a couple of them, provide payroll services to their clients and try to meet their expanding needs as they grow. Looking at its different services, the core

product, calculating and paying wages, as of the most recent quarter grew 8.7%, in part thanks to the online acquisitions. Because what Paychex does for all its clients is at the heart of their operations, Paychex has an opportunity to offer supplementary services involving managing retirement plans and other human resources functions. This is a budding but potentially highly lucrative entre.

Critics point out that Paychex traditionally had enjoyed revenue from the float, that is, it kept interest accrued on funds deposited with the company to pay wages, taxes and other fees for both employees and their employers. With short-term interest rates at microscopic levels that revenue stream has dried up. Despite that lack, PAYX is keeping revenues up, and, at some point, rates will rise. Meanwhile valuations across the board are at historically low levels, ranging from its trailing Price/Book ratio that is 66% of its average for the last decade to Price/Cash flow that is running about half of its average for the same period. Finally, the dividend at 31 cents per quarter translates into a 4.6% yield. Paychex has raised the distribution consistently over its history, and should have no trouble in keeping it growing, since the balance sheet is pristine with zero debt.

Provided you accept that eventually America will begin to grow jobs, Paychex is a superb way to anticipate that event. Meanwhile, a 4.6% yield is a good companion while you wait.

Transocean (RIG—NYSE) closed last Friday at \$54.75 and yields 5.9%, which suggests just how out of kilter these shares are in relation to the value of the company. We'll address this below.

The three stocks we recommend below are all cyclical. Each pays a significant dividend thanks to the damage their shares have suffered lately and each, we believe, will trade substantially higher once our economy regains stability.

A year ago, with the three-month long rupture at the BP in the Gulf of Mexico oil well just capped, the shares, traded at \$57.93. The following May, they topped out at \$85.57 buoyed by fast-rising energy prices and expected heavy demand for RIG's equipment and expertise, receding anxiety over RIG's liabilities for the environmental damage caused by the oil spew and confidence that economic growth for the global economy was on the horizon. Since then, each of these positive themes (except for the question of liability) has lost ground. Last week, Transocean reported results for Q2 and came in short of analysts' expectations. It was not a good week to disappoint the critics and the shares suffered.

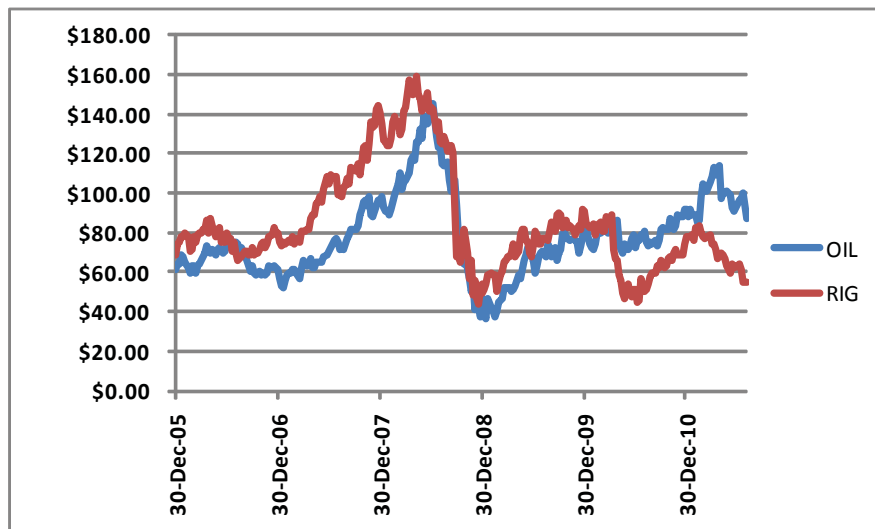
Transocean, despite the damage the company incurred from the April 2010 explosion that destroyed its Deepwater Horizon rig, killed 11 workers and spewed oil into the Gulf of Mexico, remains the industry leader for ultradeepwater wells with a fleet of 135 rigs ranging from those capable of reaching as far below the ocean and then deeper below the seafloor than any existing rigs (27 rigs capable of working in water depths of 7500 to 12,000 feet and reaching between as much as another 28,000 feet below the surface) to others that work in shallow waters. Demand is strongest for the ultradeepwater and deepwater equipment with day billings now approaching \$500,000 for the most cutting-edge rigs. The essential determinants for demand and billing rates are the availability of rigs and the price of energy, which though elevated has been volatile for years with the apex hit in July 2008 at \$144 a barrel and the bottom in February 2009 at under \$38. More recently we saw oil peak at \$114 last May. Now we are back to the mid-\$80s. This chart shows the relationship that broke down immediately following the Macondo well blowout as Transocean shares tumbled from \$88.89 just before the event to \$42.58 at the bottom. They continue to move in tandem but the price relationship has been broken.

The trend in new contracts points to rates well above

Transocean's ultradeepwater rigs are in service, and only five of 21 deepwater rigs are currently not under contract.

So why hasn't RIG realized its value? First, though demand for its high performance rigs is high, Transocean also owns a large number of standard jackup rigs that not only don't command premium day rates but also are not in high demand throughout the industry. One solution would be for Transocean to split off these assets into a new company, much as it did when it disposed of its shallow and inland drilling rigs through its spinoff of Todco. Wall Street would be happy to give RIG a higher valuation were it composed solely of deep and ultradeepwater rigs. Second, anxiety over whether we are heading back into recession that would reduce for a time the price of oil puts a cloud over the share price for all drillers. Finally, though we are confident that the contract RIG has with BP that will indemnify Transocean for almost any conceivable liability associated with the Macondo disaster is solid, the likelihood, however remote, that Transocean could suffer significant damages, cannot be 100% put to rest. BP continues to contend that both Transocean and Halliburton, which was responsible for capping the well and whose cement job failed, was in part responsible for the disaster and should shoulder not just blame but costs as well.

But at current valuations RIG is just too seductive to pass up. RIG traditionally has traded at a premium to the S&P. Over the last year, earnings were depressed due to higher maintenance costs and related down time, some related to industry-wide upgrades to safety equipment, especially blowout preventers, the last line of defense against a blowout such as destroyed the Deepwater Horizon. Based on conservative projections for the coming year, we expect RIG to trade at a P/E around 8. Historically RIG has never traded this low except for 2008 and 2009 during the Great Recession. As for Price/Sales, Price/Cash Flow and Price/Book, the numbers are well under RIG's historical averages. However, the one value ratio that



\$500,000 a day. Why are deep and ultradeepwater rigs in such lucrative demand? There has not been a major land-based mega-oil field discovery made in decades. The biggest fields today and in the future are under the oceans, often in very challenging conditions. The Macondo well that ruptured, for instance, ran 5000 feet from the surface to the ocean bottom and to reach the reservoir another 13,000 feet below that. All of

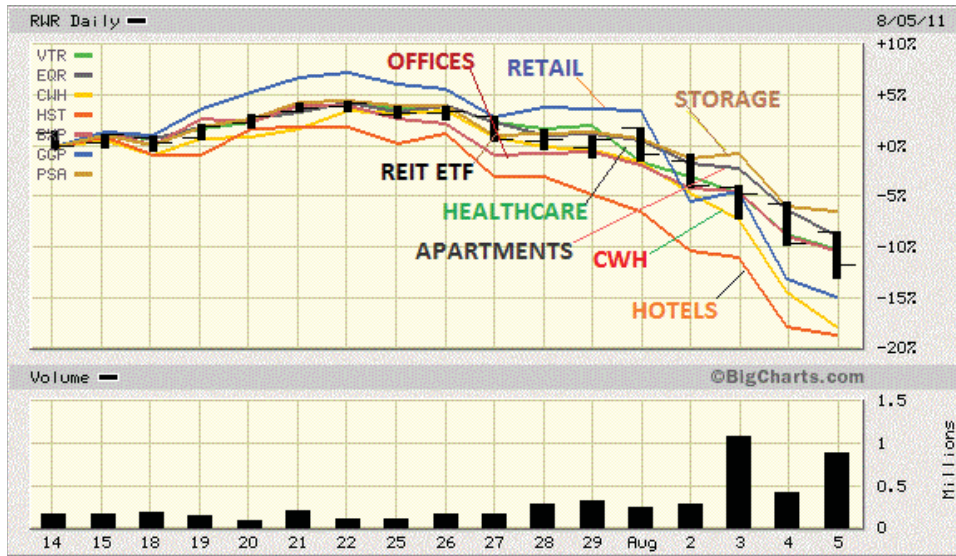
we find stunning is the current yield Transocean has not paid a regular dividend for most of this decade, and when it last did it totaled 12 cents a year. In early 2010, before the Deepwater Horizon disaster and with RIG trading at around \$80, the board of directors approved a \$3.16 annual distribution that Swiss authorities blocked after the explosion. RIG began paying the distribution in May and as was reiterated at last week's conference call, the board wants this to be a "sustainable" way of returning cash to shareholders with the caveat that should the company find a more attractive use for excess cash such as share buybacks, building new rigs or buttressing the balance sheet, then the distribution might be reconsidered. For a growth company with the prospects Transocean enjoys, a 5.9% yield is extraordinary, and itself is a reason to own the shares. For anyone who wants to participate in the energy services industry, we can't think of a more attractive opportunity.

Commonwealth REIT (CWH—NYSE) has confounded us, since its shares have traded at a persistently large discount from our calculation of its value. That gulf widened last month

after the REIT issued 11.5 million new shares at \$24, a 5.5% discount from the share price before the secondary offering was announced, which is not an unusual markdown for a secondary. What galled us, however, was that \$24 was well under where we thought its assets should be valued. As it turned out, the market very quickly recalculated what the shares were worth, and in just a few weeks, repriced them lower by 18.8% to \$19.50. Ironically, Commonwealth's price and timing of the secondary—if viewed solely as an exercise in raising capital—could not have been exercised more superbly. From the perspective of existing shareholders, however, these last few weeks have been anything but superb. If you visit Internet message boards for CWH, the tone ranges from

This is no small change for CWH, but the numbers reported during the conference call justify the shift. For the most recent quarter, 40 CBD properties produced 37% of the REIT's Net Operating Income (NOI) compared to 42% from 279 suburban buildings. The remaining 21% came from CWH's 180 light industrial and other properties. More significantly, during the quarter CBD properties saw a 2.2% increase in NOI along with a modest 0.1% increase in occupancy, while suburban properties suffered a 10.1% NOI decline and a 0.2% decline in occupancy.

Commonwealth has been issuing shares to finance its CBD purchases. In addition to last month's secondary, it also floated a new preferred, which in total put \$530 million on the balance sheet. Last year, the REIT sold 7.5 million (adjusted for the subsequent 1:4 reverse split) that added \$217 million. CWH also has been financing its CBD buys by selling off its existing properties, primarily suburban office buildings. The proceeds from these sales total \$1.4 billion. In short, Commonwealth is changing its stripes. The question is whether it is getting value in its purchases, an issue that was front and center in a recent Wall Street Journal article that focused on a pending purchase of the largest office building in New Orleans (http://online.wsj.com/article/SB10001424053111904292504576484130144850282.html?mod=WSJ_article_comments#articleTabs%3Darticle). Management notes that it is paying well below prices during



despondency and anger among longs to unrelieved chortling from shorts. That's understandable but you don't look for even keeled observations in a mental ward.

We think both sides by raging at CWH fail to recognize a much larger pattern in which Commonwealth is just a part: fears that we are entering another recession have decimated REITs, especially the business cycle sensitive sectors such as lodging, retail and offices. Look at the chart below to see how REITs in general as represented by the Dow Jones REIT ETF (RWR) have performed versus large REITs in various subsectors. They are stacking up in a classic pattern during a sell off based on fear of a severe contraction in the economy; storage doing the best and hotels doing the worst. Ironically, at the very moment commercial real estate is getting a fright, several large private equity funds are rolling out multi-billion real estate investment funds. Who knows, but if this slide in prices continues we will be filling out our portfolio with more REITs.

But back to Commonwealth, which is in the process of revising its portfolio from mostly suburban office buildings along with light industrial/warehouse properties to a 50/50 mix of suburban and central business district (CBD) office buildings plus the light industrial/warehouse assets. Why has the REIT decided to change? Simply put: because Wall Street attributes higher valuations to CBD properties whether they are hotels, offices, retail or offices.

the commercial real estate boom that went bust in 2007-2008, a similar dynamic noted for last month's recommendation of Retail Opportunities, the strip mall REIT, But not all discounts are created equal, and buying at overpriced properites at a discount still requires making a smart buy. We'll have to wait and see.

CWH has always been a high-yielding REIT. During the years it was known as HRPT Properties Trust and with its suburban properties weighted toward government, medical office buildings and senior care facilities, it emphasized high-credit, stable tenancies that required relatively small outlays for improvements, which resulted in a strong yield. Over the years, CWH spun off first its care facilities iand more recently its government buildings but has continued to be a high yielder. After what has happened to the share price, CWH is now sporting a double-digit yield. Is it sustainable?

Based on what Commonwealth's management said last month, it is secure. At present, the \$2 dividend represents 95% of cash available for distribution (CAD), though Portnoy concedes that higher leasing costs could push the payout above 100% of CAD, a not unusual situation in the short term but one that would challenge the dividend were it to persist. We believe the bear attack on REITs in general amplified investor unhappiness with CWH's secondary. We view the battered shares as very attractive at current levels. SA

Portfolio Updates

Almost nothing we report here should make you happy, though most of it should encourage you to build or add to positions. Let's dispatch with the only position that stayed in the black this month, **New Zealand Telecom**, which is up 2.9%. NZT has been on a roll, benefitting from both resolution of its competitive situation in New Zealand (it has won the lion's share of the high-speed national broadband project and is progressing on dividing its consumer from its business division) and the strong NZ dollar. Now let's move on to the rest.

Retail Opportunities Investment Corp., the July recommendation, has held its own during the market decline, helped in part by its advantageous position as an acquirer while it deploys its cash and now its credit line to buy strip malls at prices not seen since the mid-1990s. It also helps that as acquired properties add to the revenue stream, ROIC continues to expand its dividend. As part of the Q2 earnings report, management announced the quarterly dividend was increasing by 11% to 10 cents a share. There's little not to like in ROIC's story: occupancy is up 2.7% to 91.9% (and 95.5% for stabilized properties). Stuart Tanz, the CEO who enjoyed remarkable returns from his last turn at running Pan Pacific, another strip mall REIT that he sold off in 2006 as commercial real estate peaked, continues to buy shopping centers, many of which are ripe for retuning with more solid tenants. What does "held its own during the market decline mean"? ROIC since the last letter was priced on July 8th is down 2.8% while RWR, the Dow Jones REIT ETF, is off 14.6%. **Associated Estates**, the apartment REIT, had a good quarter, reporting Funds from Operations increased from 17 cents in Q2 last year to 27 cents this year. Revenues jumped 30.6%. But it could not stand up against the market collapse, falling 6.7%, yet that is far better than the REIT ETF's 14.6% drop. More specifically, an apartment sector REIT (REZ) over the same period dropped 12%, only slightly better than did the biggest apartment REIT, Equity Residential, which fell 11.4%. **CGM Real Estate Fund** is tied not just to REITs but to a core of natural resource shares that Ken Heebner owns now and again, justifying their inclusion with the somewhat fanciful notion that since their products are wrested from the ground, they are just as much "real estate" as is a shopping mall or an office building. In a market in which sellers are positioning themselves for a return to recession, natural resource shares, as we'll see below, also had a rough month. Since the last letter, CGMRX is down 16.5%. See Page 4 for extensive comments on **Commonwealth REIT**. The strength most natural resource shares have enjoyed resulted from expectations of a stronger global recovery that would demand metals and energy and a weaker dollar, which mechanically amplified the value of such assets denominated in dollars. Both of those supports have given way. Hence, if we look at sector ETFs for materials and energy, which most approximate the natural resources sector, we see significant declines since the last letter: XLE, the energy ETF, is down 11.3% and XLB, the materials ETF,

is off 14.8%. In our own portfolio, there were no exceptions. When the CEO for Anglo American, the mining conglomerate, recently spoke after good Q2 earnings were announced, she noted "Twenty million people – the size of the population of Australia - are moving to cities on an annual basis in China. The Chinese have now committed to a five year social housing project where they are going to be building 10 million houses and all of the commodities we produce will go into those projects. It's not just China, it's India and Brazil, Iron ore and Copper demand is going to be very high..." Earnings were higher than anticipated despite poor weather's impact on what could be pulled out of the earth and currency headwinds. Operating costs also were higher. But Wall Street was not interested: natural resources are out of favor, and there is skepticism over whether China will carry through on these plans. AAUKY is down 18.4% since the last letter. Elsewhere in natural resources, Agrium, the Canadian fertilizer company, is down 10% despite reporting better than expected results for Q2. However, the second half of this year should produce even better results as demand for grain as well as other agricultural products remains high. Energy has been moving down as oil seems to have given up for now its attraction to \$100 per barrel and today closed at \$86.06 a barrel. EnCana is getting hit by disappointment over its failed deal with PetroChina to develop its shale deposits. Still, results for the quarter were good and, presuming demand for natural gas picks up, ECA at current prices is attractive, certainly more attractive than it was in the July issue. Since then, ECA is off 16.2%. Fidelity Select Natural Gas did better than ECA, dropping 8.9%. See Page 3 for extensive comments on Transocean.

Plum Creek Timber, technically structured as a REIT, reported a 29% increase in earnings (up six cents to 27 cents a share) but guided full-year results lower due to weak demand for wood and wood products. The economy, management noted, remained slow and erratic. Since the July letter, PCL is down 14.33%. The yield is now 4.6% and the shares remain a good place to wait out the weak economy.

Leucadia, which the market often treats as a natural resource company because it has exposure to several mining companies, dropped 16.8%. Contributing to that fall is the other major concentration for LUK: financial services. The SPDR Financial Services ETF (XLF) dropped 13.3%.

As for our two water positions, **Tetra Tech** and the **PowerShares Water Resources ETF**, in which TTEK is a major position, TTEK surprised skeptics with very strong results for Q3 and year to date: the quarter showed a 19.8% jump in revenue, net income was up 15.5%, backlog was up 11.8%; for the first three quarters, revenue increased 20.6%, net income was up 18.6%. Management was optimistic about the coming year. What we found most encouraging is that revenue growth is coming not from government but from commercial clients, especially international clients. Yesterday, when the market

collapsed, TTEK was our only money-maker but today the knives came out and the shares lost 5%, which brought the damage since the last letter to 14.8%. The Powershares fund tumbled 18% as the market slaughtered industrial companies, which would lose revenues should we return to recession. As for USAA Precious Metals & Minerals Fund, though gold drew massive buying as a safe harbor, gold mining shares did not because they were valued not for the assets they possess but because owning paper shares became inconceivable. USAGX dropped 2.6%.

U.S. Treasuries rivaled gold as a safe harbor with rates on the 10-Year Treasury Note dropping at one point to as low as 2.4%, which at the time seemed foolish given that rating agencies were considering whether the U.S. after the feckless debt ceiling “negotiations” had lost its AAA credit rating. But that didn’t seem to bother anyone, and money flooded into Treasuries. An alternative explanation would be that investors are anticipating a very, very deep recessions and/or severe deflation, which might justify buying Treasuries. This evening S&P did announce that it had demoted U.S. debt to AA+, the first time U.S. debt has ever not been AAA. For the **ProShares UltraShort 20+ Year Treasury ETF** tumbling yields and rising U.S. debt prices translated into a 14.9% drop. At some point the bottom is going to drop out of longer-duration Treasuries, but we’ve given up trying to predict when.

Our other debt-related positions, the **PowerShares Senior Loan Port ETF**, which holds bank loans made to less than investment grade companies is down 3.9% and the **Third Avenue Focused Credit Fund**, which holds high-yield longer duration paper, dropped 3.7%. Both funds hold debt that is more correlated to equities than to Treasuries, and when the market gets worried about corporate earnings in a recession, they take a hard look at high-yield and less than investment grade debt.

Healthcare, which usually is also something of a safe harbor, isn’t now. The least impacted positions were **Johnson & Johnson** (-7.2%) and **Boston Scientific** (-9.5%). Despite continuing recalls, JNJ beat analysts’ target earnings and seems to be coming out of the funk it’s been in for more than a year. Boston Scientific also had an encouraging quarter, coming in at the higher end of its guidance for sales and earnings above expectations. The company announced it expected to layoff 1400 employees worldwide. There is some concern over how the FDA is going to revise its fast-track approval procedures for medical devices. Clearly they will be tightened, though it seems unlikely the FDA will adopt a radical reconsideration of the approval process recommended by the Institute of Medicine. We’ll have to wait to see how this impacts BSX and **Stryker**, which fell 16.8% after it announced excellent revenues but earnings per share 3% (one penny) below last year’s quarter. The reason? Costs associated with two acquisitions. Were these costs excluded, SYK would have turned in a 10% increase. **United Health**, the HMO, dropped 12.5% over concerns that the budget deal worked out to raise the debt ceiling would mean cut backs in Medicare and Medicaid payments. Other HMOs had similar drops. In UNH’s case, all of the Q2 earnings

numbers were strong, and management raised estimates by 20 cents to somewhere between \$4.15 and \$4.25.

Pfizer, which is about to lose patent protection for Lipitor, its biggest profit maker, dropped 13.2%. The Lipitor story is old news, long since factored into PFE’s share price. Prescription drug sales, however, did slide 3%, a function, we believe, of a tight economy that discourages people from seeking medical care. Aside from that, there was nothing discouraging in the Q2 earnings report, with numbers above analysts’ expectations.

Hambrecht & Quist Life Sciences Fund got clobbered when one of its largest positions, Dendreon, lost nearly 65% after announcing that sales of Provenge, its prostate cancer drug, were far below expectations. That was bad enough for HQL but the anxiety such news provoked for the entire biotech sector hit other positions as well. Since the last letter, HQL is down 15.9%. The worst performer—and the one with some of the best results for the quarter—has been **AHM Healthcare Services**, which provides traveling nurses and other temporary medical professionals. It’s been a remarkably successful recommendation, until now, as the shares responded to rising sales and profits and to the sense that medical workers are in high demand. The Q2 news only reinforced this trend: revenues, thanks mostly to an acquisition, jumped 57% and operational margins expanded 1.2% to 3.5%. What concerned analysts apparently were comments about difficulties in recruiting nurses for short-term assignments. That means higher wages, which at present are difficult to pass on to clients and thus could cut into revenues. We think AHS can survive this and wonder what Wall Street was thinking when it slashed the share price today by more than 12%, which brought AHS 23.8% below where it closed last month. As for Paychex, which marches to a similar drummer, see Page 2 for a complete discussion.

Among funds, the best performer has been the Columbia **Seligman Premium Technology ETF**, which is built to do best in modestly rising or flat markets but also provides some insulation in down markets. STK dropped 7.2% versus 11.5% for the Nasdaq. The Davis Financial Fund outperformed its ETF sector equivalent, falling 9.7% versus 13.3% for the XLF. The rest of our funds, with the exception of HQL (see above) either kept pace with their benchmark’s or did slightly better.

As for technology positions, **Microsoft**’s earnings for Q4 came in at 69 cents a share, a dime higher than analysts’ expectations. The surprises were higher sales for the Office suite of applications and for its Xbox videogame console. Sales in the server and tools division, which deals primarily with corporate clients, also rose nicely. On the negative side, sales of the Windows operating system dropped slightly but the most significant drain on profits came from the Internet division, which is at war with Google and continues to invest heavily in that battle. For the month, MSFT held up well, falling 4.6%. **Symantec** reported results improving not only over last year’s quarter but also beating analysts’ expectations (adjusted income came in at 40 cents a share versus consensus of 37 cents). None of that prevented the shares from falling 13.3% **SA**

Income With Growth	Symbol	Exchange	Price *	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.99	4.25%	\$18.00	BUY
CommonWealth REIT	CWH	NYSE	\$19.50	10.26%	\$25.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$10.80	3.33%	\$12.00	BUY
Telecom New Zealand	NZT	NYSE	\$10.65	6.03%	\$11.00	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$80.78	0.27%	\$100.00	BUY
CarMax	KMX	NYSE	\$28.85	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$25.34	2.44%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$21.88	2.07%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$32.70	3.04%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$100.13	1.29%	N/A	BUY
Fastenal	FAST	NASDAQ	\$31.59	2.25%	\$38.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$19.81	1.82%	N/A	BUY
Honeywell	HON	NYSE	\$47.98	2.78%	\$62.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$24.60	0.65%	\$32.00	BUY
Johnson & Johnson	JNJ	NYSE	\$62.71	3.64%	\$71.00	BUY
Leucadia National Corp.	LUK	NYSE	\$29.60	0.84%	\$38.00	BUY
Mattel	MAT	NASDAQ	\$24.50	3.76%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$25.68	2.49%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$42.53	2.26%	\$50.00	BUY
Paychex	PAYX	NASDAQ	\$27.09	4.58%	\$40.00	BUY
Pfizer	PFE	NYSE	\$17.49	4.57%	\$23.00	BUY
Stryker Corp.	SYK	NYSE	\$50.04	1.44%	\$70.00	BUY
Superior Industries	SUP	NYSE	\$18.87	3.39%	\$27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$20.08	0.00%	\$30.00	BUY
Third Avenue Value Fund***	TVFVX	800-443-1021	\$48.01	2.01%	N/A	BUY
Time Warner	TWX	NYSE	\$31.74	2.96%	\$40.00	BUY
United Parcel	UPS	NYSE	\$65.69	3.17%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$45.56	4.57%	\$53.00	BUY
Wal-Mart Stores	WMT	NYSE	\$50.85	2.87%	\$60.00	BUY
Xerox	XRX	NYSE	\$8.53	2.02%	\$12.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$20.50	0.00%	\$30.00	BUY
EnCana	ECA	NYSE/TSE	\$25.58	3.13%	\$34.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$31.50	0.17%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$36.51	4.60%	\$44.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$16.65	1.07%	\$21.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$39.10	11.78%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$6.39	0.00%	\$9.00	BUY
Boston Scientific	BSX	NYSE	\$6.49	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$25.29	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$10.61	8.20%	\$11.78	BUY
Maxim Integrated	MXIM	NASDAQ	\$21.62	3.89%	\$29.00	BUY
PowerShares Senior Loan Portfolio	BKLN	NYSE	\$23.93	3.86%	\$27.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$17.86	10.37%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$17.10	0.00%	\$22.00	BUY
Tellabs	TLAB	NASDAQ	\$3.93	2.04%	\$5.50	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$10.92	8.04%	N/A	BUY
Transocean	RIG	NYSE	\$54.75	5.77%	\$75.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$28.41	0.00%	N/A	BUY

* Prices as of Friday, August 5, 2011

** Yield represents all distributions during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.

*** Note ticker symbol changed to TVFVX

BUY, HOLD, SELL OR LIMIT IN **BOLD** INDICATES A CHANGE IN ACTION OR LIMIT

The rising swell of home foreclosures began in 2007 as a symptom of faltering real estate markets across the country. But as the swell turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US and worldwide economies. Indeed, the state of the nation's real estate markets and the economy have become one and the same. Clearly, the recession cannot be fully put behind us and a recovery kick into full gear until the inventory of foreclosed homes stops overhanging the market.

We have seen all this before. It was back in the 1980s. After years of loose and questionable lending practices, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate onto an already-depressed real estate market. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts. The crash was worse in some parts of the country, but the damage to the whole US economy was substantial. Does this sound familiar?

We have the same situation today. It's like the old good news/bad news jokes, except this is no laughing matter. The bad news is that today's crash has been damaging to both real estate prices and the national economy.

The good news is that we have the tools to determine when the bad news will be over. This will give us a tremendous opportunity not only to invest in real estate for pennies on the dollar at the right time, but also in other investments as well as those that benefit from a recovering economy.

The Key Indicator

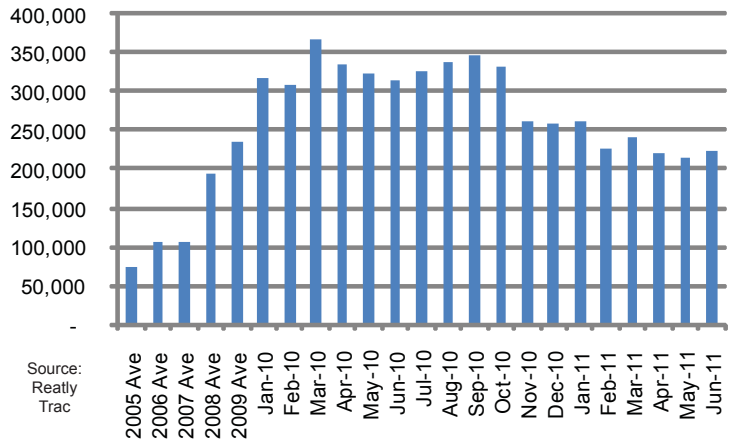
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We use some of their data here to gauge the state of the nation and its real estate, and plan to continue to do so in future issues of **SoundAdvice**.

What we are looking for is a significant decline in the number of foreclosures. When this happens, the bulk of the overhanging inventory of foreclosed properties will have been digested, and the real estate recovery can then begin as well as in the economy. In the late 1980s, this was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began. For nearly two decades, fortunes were made from real estate purchased for pennies on the dollar during the S&L Crises of the 1980s.

The following chart shows US foreclosure rates. In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the fourth quarter. At first, the decline looked like the decline was a temporary lull due to a freeze in foreclosures during the quarter. However, foreclosure rates have since been staging a bumpy decline, with an uptick in June, the latest data available.

US Foreclosure Rates - Monthly Averages



Source: Realty Trac

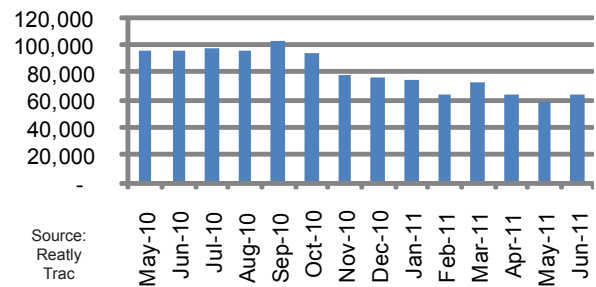
Dissecting the Foreclosure Process

It's important to keep in mind that the foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures is actually the aggregate of the number of properties in each of these three stages.

We can get an early glimpse of a change in trends by focusing on changes in the first step of the foreclosure process: new default filings. After all, a significant change in the first step of the foreclosure process must ultimately lead to a significant change in the aggregate number.

The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month. However in November they began declining and have dropped to a low of 58,815 in May, and increased in June to 63,863, the latest reading available.

US New Default Notices



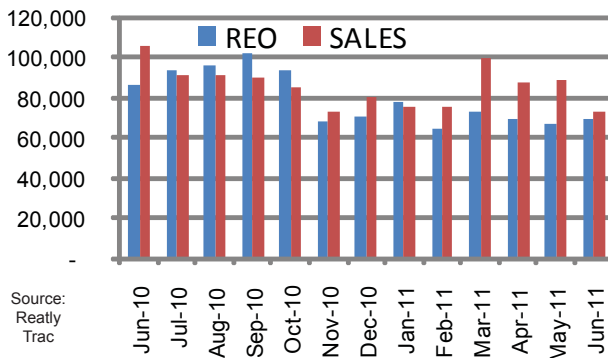
Source: Realty Trac

The fact that new default notices have continued to decline in general is significant. It is a positive sign that the problem is no longer accelerating.

The Inventory

At the other end of the foreclosure process is what the banks have not been able to sell. This inventory is called "real estate owned", or REO for short. Each month more REO is added to the inventory. However, each month there are a number of properties sold from the inventory. Below

is a chart of the REO (in blue) and sales (in red) during the last year.



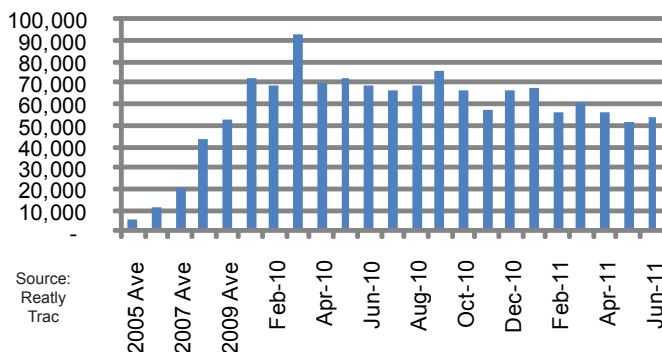
On balance, there has been 84,576 more properties sold than have been added to the REO inventory, or 5.2 percent of the inventory of 1,624,786 foreclosure properties listed for sale -- not much progress.

Where are the Foreclosures?

While the foreclosure crisis is a nationwide problem, the bulk of foreclosed properties are not evenly scattered across the country. More than one-half of the foreclosures are in only 5 states - California (24.3%), Florida (10.7%), Arizona (6.0%), Michigan (5.8%), Illinois (4.9%). and Nevada (4.5%).

Nevada has earned a reputation as the foreclosure capital because it has the highest number of foreclosures in relation to the number of houses there. One of every 114 houses was foreclosed upon in June, which was the highest concentration of foreclosures in the nation (as compared to one in every 584 nationally). While that may be important to a homeowner or real estate investor in Nevada, other states are a larger burden on the national economy. California and Florida accounts for more than two-thirds of the nation's foreclosures. Any changes in these states should lead to a significant change in the trend for the national economy as a whole. Take a look at the chart below of California Foreclosures.

California Foreclosures - Monthly Averages

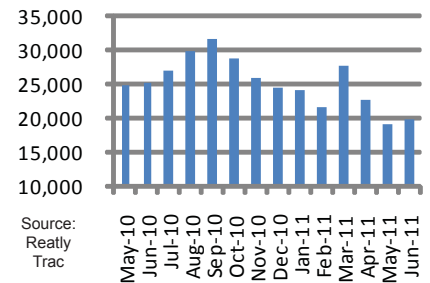


In 2005, California foreclosures averaged 5,138 properties per month. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Although foreclosure rates have declined

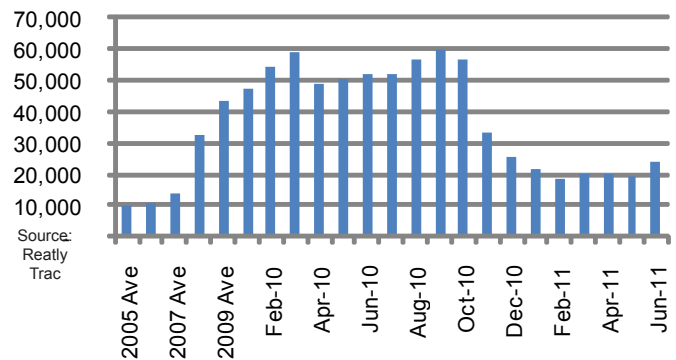
somewhat, they are still historically high and the slight downtrend is not convincing.

Except for the spike in March and the 4 percent increase in June, new default notices in California have been declining. (shown on the right.)

California New Default Filings



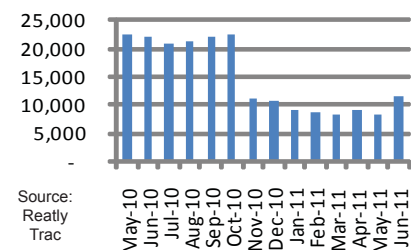
Florida Foreclosures - Monthly Averages



In Florida, foreclosures climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the rate dropped sharply. However, June saw a significant 24 percent increase. See the chart above.

New default notices in Florida also increased significantly in June by 43.8 percent. See the chart to the right.

Florida New Default Filings



Conclusions

The fact that new default notices have been declining nationally indicates that we are witnessing the beginning of the end of the entire crisis. However, the increases in June are not encouraging, especially in Florida.

We must still keep a close eye on the inventory of foreclosures held by lenders because it represents the mass of the problem that must ultimately be worked out to free the economy of this burden. So far, we do not see significant progress on the national inventory.

We will be tracking foreclosure metrics closely both nationally and in key states in these pages of **SoundAdvice** to be among the first to know when the end of the foreclosure crisis is at hand. Stay tuned.

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 a "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 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 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 \$7,066,235 in stocks and to \$1,251,064 in houses.

But though an investment begun 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 Risk Indicator he would have made \$280,853,829, 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 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. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying Real Estate Investment Trusts (REITs.) Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, REIT shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.54. This reading reveals that stock values are slightly above their average relative 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 **Sound Advice** 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 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 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 economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that

signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. The current reading is 0 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which would reveal an overheating economy with immediate inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 33.3 percent.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual average return of 21.5 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent during caution periods.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

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 subscription, and you will also receive an updated copy when you renew your subscription.)

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