

SOUND ADVICE

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Bill Gross, Chief Investment Officer at bond powerhouse Pimco, has a new employee. Alan Greenspan, the retired Maestro of the Federal Reserve, has been hired by Pimco as a consultant.

A Bloomberg columnist thinks Greenspan's first job will be to set his new boss, Gross, straight on interest rates, since Gross, according to the author, believes the U.S. housing market is in such terrible shape that the Fed will be forced to lower rates.

Greenspan thinks housing is not so terrible, and that interest rates are headed higher because the global savings glut (not here in the U.S., of course—we specialize in borrowing) that had created so much cheap capital is slowing. As a Wall Street institutional investor noted, they both can't be right.

In fact, Gross has two views, one short term and one long term. For the next six to 12 months, Gross is bullish on short-duration bonds, but his views converge with Greenspan's for the next three to five years. Gross is convinced that long-term interest rates are headed higher, perhaps as high as 6.5%. He worries about continuing increases in commodity prices. Furthermore, labor costs, which have been the primary advantage enjoyed by emerging economies, especially China, are starting to rise. He also sees a taste among institutional investors and even central banks for higher risk investments.

From our perspective, the timeline Gross sets out seems too extended. As we suggest elsewhere in this issue, we're not talking an interest rate Armageddon. Rather, we do expect something worse than the Pollyanna market projects.

—Gray Emerson Cardiff

A Buy Signal Amid Inflation

As noted on Page 10, the *Sound Advice* Diffusion Index of Leading Indicators this month fell to zero based on the most recent Conference Board data, which triggers a Buy Signal, since weak leading indicators demonstrate an economy that has slowed, usually a good time to be buying stock. This was not entirely unexpected, since GDP growth for the first quarter had been revised in early June deeply lower from 1.3% to 0.6%, which brought the economy to a tortoise-like 12-month growth rate of 1.9%. Under these conditions, we can be more comfortable with less defensive positions.

All of this is occurring in a suddenly changed interest-rate environment that seems to have left most Wall Street types shocked. As one market observer, who manages \$52 billion, exclaimed: "It's astounding to me that yields moved as quickly as they did." However, the Fed repeatedly has worried publicly about inflation, especially because many expect the U.S. economy to pick up in the second half. As we write on June 15th, the 10-Year note yields 5.16% and the 2-year 5.02% compared to 4.65% and 4.68% when we last priced the portfolio on May 4th. But is it really all that astonishing?

This previous week has been bizarre: stock prices tumbled midweek in response to surging long-term interest rates, which was followed by two days of retreating rates and surging stock prices. Consumer Price Index and Producer Price Index figures topped off the week, and if you are comfortable with ignoring the continued upswing in energy and food prices, these reports should make you confident that inflation concerns are misplaced. However, if you believe, as do we, that not only are energy and food costs going to remain high but that they will presently push other prices noticeably higher, you are stunned by the complacency about interest rates and inflation that regained its hold on Wall Street.

Wall Street's schizophrenic hope that the U.S. economy would remain strong enough to keep earnings on track yet wobble enough to get the Fed to cut rates and the feeble argument that foreign lenders would keep a cork on our own interest rates set the market up for the rate shock that hit this week. The retreat in rates does not validate that optimism. Instead, we think it is the temporary triumph of hope over experience.

Suddenly, foreign sources for cheap money are shutting down. In fact, many of the world's central banks have embarked on raising rates as they see their economies heating up. The Conference Board country-based

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A Buy Signal Amid Inflation

economic reports that demonstrated a slowing U.S. economy last month were at the other end of the scale for foreign economies: the U.K for April up 0.6%, Japan 0.2%, Australia 0.5%, Germany 0.4%, Spain 0.9%, Mexico 1%, and France 0.4%. Central banks, with the exception of Japan, which can hesitate only a bit longer, are raising rates to cool their economies. China is again expressing anxiety about overheating, but lacks the tools to control its own economy even were officials not worried about the political consequences of decelerating that growth. Despite two increases in the central bank lending rate, the Chinese economy continues to accelerate.

In the same article quoting the astonished Wall Streeter, the author notes that the S&P 500 might be close to "fair value," referring apparently to the so-called "Fed Model" that compares the S&P's earning yield with that of the yield on the 10-Year Treasury to gauge what price the S&P should command. But a month ago, when interest rates were lower and the S&P stood not far from its current price, bulls were touting the Fed Model as demonstrating that the S&P was at least 15% underpriced. At the time, we wondered whether that oft-invoked model might be predicting not higher stock prices but higher interest rates. Let me explain.

THE FED MODEL

"The Fed Model" endows this predictor with more authority than it deserves because no one at the Federal Reserve ever has claimed this is their lodestone for fairly valuing U.S. equities. But on Wall Street, which always wants reassurances about how valid values are, especially when the projected values are bullish (during the bubble, the Fed Model suggested the S&P should have been 60% lower, but, as everyone knew at the time, it was different that time, so the Fed Model was ignored), the Fed Model has become a simple touchstone for how cheap or expensive the market is.

So how do you calculate the Fed Model? It's simplicity itself: divide the projected earnings for the S&P 500 by the yield on the Ten-Year Federal Note. In effect, you are comparing the 10-Year Note's yield to the S&P's earnings yield (the S&P's earnings yield is calculated by dividing the projected earnings of the S&P 500 by its

current value, and is the inverse of the S&P's P/E). If the S&P's earning yield is higher than the yield on the 10-Year, then according to the Fed Model the S&P is underpriced. If the bond yield is higher than the S&P's earning yield, the S&P is overpriced.

If Wall Street prefers to see the Fed Model as a predictor for "correct" stock values based on the 10-Year Treasury's yield and estimates of future earnings for the S&P 500, why can't we also plug in the current value of the S&P and the current estimate of earnings to estimate what those numbers suggest the "correct" interest rate should be?

All we are saying is why can't the Fed Model be used to project what the 10-Year Treasury's yield should be or for that matter the earnings estimate for the S&P? Currently, using figures from the June 16th *Barron's*, the S&P's earnings yield is 5.44%, while the 10-Year yields 5.17%, which implies the S&P might be undervalued by 5.3%, or the correct interest rate might be 5.4%, or the correct earnings estimate for the S&P might be \$79.19. In short, we're not confident that the Fed Model is a great predictor, though we are willing to say that should interest rates go vertical, the overall stock market would have a hard time. At this point, we don't expect a vertical movement in rates, and, based on our indicators, think we can see higher share prices.

WHAT TO DO?

If we now have a buy signal and simultaneously are finally seeing the inflation scenario begin to gain traction, we expect our investments in hard assets will prosper. We also expect that defensive positions in healthcare and medical devices, in food and beverages also will attract investor dollars. If the economy in fact is about to pick up, downtrodden growth stories like **Microsoft**, **Symantec**, **Maxim Integrated**, and **Sprint Nextel**, and infrastructure stories like **Insituform** and **Tetra Tech** are well positioned. Though REITs have the potential to keep up with inflation as rents rise, we are concerned about income investors moving to debt instruments and about how more expensive borrowing costs initially might impact the sector. See the Updates on Page 9 for more comment. **SA**

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A Window of Opportunity

This month's recommendation was intended to be a technology mutual fund. Over the last year, we have introduced a bit of tech when we felt there was value such as **Symantec**, a security software designer, when its share price plummeted after having overpaid for an acquisition, and **Maxim Integrated**, a semiconductor designer, while its sector works through inventory problems. We are still interested in expanding our exposure to the broad category of technology. In general, we believe, in the market's rush to distance itself from overvaluation of tech stocks leading up to the 2000 Crash, from which the Nasdaq has not recovered, it is likely that Wall Street is underpricing the sector's potential.

But when sifting through mutual funds focused on technology stocks, we repeatedly ran into essential disagreements with how these funds manage their portfolios. The biggest problem, we concluded, is their high turnover rate, since thigh turnover not only creates a cost drag on performance but even more important, suggests managers cannot focus on long-term performance. Rather than looking for long-term value, the tech funds we considered appear to be looking for that elusive magic mixture of positions to produce profits immediately.

We decided to select one stock as a surrogate for the entire sector, **Microsoft (MSFT—Nasdaq)**, which is the largest technology name in terms of market capitalization (\$283.4 billion), and by far the largest software firm (Oracle is next, at a third of MSFT's sales and market cap), and brings together a near-essential role in the ubiquitous personal computer world through its software, considerable strength in serving corporate clients, and broad potential on the Internet. Yet MSFT (nor those other three Horsemen of the Bubble, Cisco, Intel and Dell) has not even kept up with the Nasdaq since hitting its high at the end of 1999. If technology stocks, especially software-centric stocks, prosper, Microsoft should be a profitable investment.

No, we are not suggesting that MSFT overnight deserves to regain its all-time high of \$60 hit at the end of 1999. We are saying that at current valuations, MSFT is relatively cheap, and even if it merely holds its place relative to software competitors, will more than keep up with the overall market. If the brains in Redmond, Washington can make serious money on the Internet, the rewards would be substantial.

MICROSOFT

A description of Microsoft might seem unnecessary, since who doesn't know what Microsoft does? However, the critical aspect of Microsoft is not its ubiquitously dominant software, nor even its presence on the Web through MSN, but how it is positioning itself to compete in the future. So a little review is worthwhile.

Microsoft has organized itself into three broad divisions: Platforms and Services, Microsoft Business, and Entertainment and Devices. For the third quarter of FY2007, the most recently reported period (closed on March 31), far and away the largest division, Platforms and Services, accounted for 55.6% of revenues and 81% of operating income. P&S generated that income from the sale of operating systems such as Windows XP and more recently Windows Vista introduced at the end of 2006 and the start of 2007, and from operating systems dedicated to servers and other commercial-strength applications. P&S also is responsible for consulting services that support both individual and corporate level accounts, and from MSN, which generates the lion's share of its revenues from advertising that appears on its various sites. The Business Division, is responsible for 31.2% of sales and 53.6% of operating income, while the Entertainment and Devices Division drew 13.2% of sales while generating a loss of \$749 million. The apparent overstatement of operating earnings between Platforms and Services and the Business Division (the two divisions total 134.6%!) results from how Microsoft attributes costs for internal transactions. No surprise that the dominant divisions sell what Microsoft is best known for: software, especially operating systems, and the Internet, particularly Internet advertising.

Results for the third quarter exceeded expectations. Of particular interest to us was the remarkable increase in operating profits in the Business Division, which often is overlooked by observers who focus only on revenues from operating system and application sales. For the first three quarters, Business accounted for more revenue than any of the Platform & Services components, and with only 34% of their combined revenues, generated 90% of their combined operating profits.

In April, management projected better than anticipated sales and earnings per share for the balance of

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2007 and into 2008. Much of that expected increase will come from sales of newly introduced Vista and the concurrent release of bundled common applications (Word, Excel, and PowerPoint) in Office 2007. Over the balance of the year, Microsoft will be rolling out new server software as well as new Internet search products.

THE INTERNET AND SOFTWARE

Microsoft's success has relied on providing local computers and networks with software specific to each computer. My office desktop, my home desktop, my laptop—each has its own copy of Windows, its own copy of Microsoft Office and its own copy of various other applications. Each copy, licensed by its manufacturer, was loaded from the manufacturer's CD. However, the Internet is shifting how we use our computers and how we access software. Over time, we can expect that instead of owning our local versions of any software application or operating system, we will access and use the most recent version from a remote server controlled by the software's owner, which we hope will be Microsoft.

The folks in Redmond appreciate how use patterns will shift away from individual, isolated PCs or linked together in networks to share data, to PCs communicating with a software vendor's central server for most if not all of the functions now stored locally. Not only would such a linked system allow users to always run the most recent software version but it would also make updating and bug fixing quick and universal. Finally, a centralized source for software would create new obstacles for counterfeiters, who depending on where you live account for as little as the 22% of copies sold here to 95% in Armenia. China gets 82% of its software from counterfeiters. It's not just software pirates that worry Microsoft. Online competitors such as Google are preparing to introduce applications such as a word processor and a spreadsheet that would compete against Microsoft products. Yes, they are stripped down compared to the rich functionality of the Microsoft versions, but their price is attractive: free.

These are battles Microsoft will fight in the future. Right now—and for the foreseeable future—

Microsoft's greatest challenge is catching up with Yahoo! and Google for Internet advertising dollars, which means that Microsoft to attract those dollars must have not only the proper technical environment to launch complex advertising campaigns but also must have online features that draw and hold viewers. This is where Microsoft today is pouring cash and creativity.

THE INTERNET AND ADVERTISING

Microsoft has poured billions into developing an online presence that is built around its browser, Internet Explorer, which is folded into Windows, and around MSN.com. Internet Explorer today is the browser of choice for more than 80% of users, though this represents a decline from earlier in the decade when usage was as high as 95%.

Note that the Online division lost almost \$500 million during the first nine months of the current fiscal year as management increased staffing, while paid subscriptions continued to decline. As AOL demonstrated when turning from a subscription-based model to a free for all that depends primarily on advertising to generate

revenue, no one is counting on subscribers to make money.

The biggest difference today versus 2000 when Internet stocks crashed and burned is that Internet companies—especially Yahoo! and Google—are figuring out how to make money from the Web. Over the last few years, MSFT has made relatively small, strategic acquisitions to bolster various aspects of its businesses. Typical were the first three quarters of the 2007 fiscal year. Microsoft made 11 acquisitions for a total cost of about \$550 million. However, last month Redmond announced that it was buying AQuantitative, a digital marketing company. Steve Ballmer, Microsoft's CEO characterized the \$6.5 billion acquisition as “the next step in the evolution of our ad network that began with our initial investment in MSN...” In fact, harnessing AQuantitative's marketing tools and relationships to Microsoft's assets acknowledges that when compared to Yahoo! and especially to Google, Microsoft lags in finding ways to extract revenue from the Internet. In fact, Microsoft was compelled to buy somebody like AQuantitative in response to Google's acquisition in April

Based on MSFT's valuations between 1991 and 2006, today's price ratios are inviting, and even if we exclude the bloated valuations for 1998-2000, the numbers remain attractive.

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of DoubleClick, which provides many of the abilities AQuantitative brings to Microsoft.

Yahoo! pioneered wringing advertising dollars from the Internet but Google has raised it to a high art by first addicting Internet users to its highly effective search engine, and then accessorizing the search tool with a phalanx of equally compelling functions such as a search engine for images, its own web-based email network, and maps and local imaging. These tools are free, but by cementing users to its sites these features effectively generate advertising dollars. Not only are the results for Google searches larded with ads for related products but Google lets advertisers, for a fee, place their links above others regardless of whether Google's scoring system rates them that highly.

The AQuantitative acquisition signals that Microsoft's agenda places revenue from the Internet among its highest priorities as it struggles to gain on Google and Yahoo!. What about rumors that the company would like to acquire Yahoo!, which surfaced again last month? Currently, YHOO has a market cap of about \$37 billion. Add to that a modest premium, say 20%, and you are talking about an acquisition cost of \$44.4 billion, just about MSFT's total current assets. However, though such a deal is not beyond Microsoft's means, we doubt it will happen. In fact, the AQuantitative deal suggests Microsoft has decided to go it alone against its prime Internet peers.

TECH'S FAVORITE VILLAIN

Microsoft's dominant (dare we say quasi-monopoly as an operating system and basic business applications?) has been a magnet for government scrutiny and lawsuits. When we lived in an applications-centered universe, competitors charged Microsoft either crushed them through unethical or illegal means, bought them out, or designed Microsoft programs with the intention of marginalizing them. Similar charges have continued into the Internet age. Indeed, in the late 1990s the Justice Department pursued Microsoft for how it bundled software to discourage consumers from using non-Microsoft Internet tools. Washington even threatened to break up this technology juggernaut into two companies: one in software and the other focused on the

MSFT Valuations With and Without Bubble

	All Years	Years Excluding 1998-2000	Current
	1991-2006	1991-2006	
P/CF Avg Low	20.7	18.8	22.4
P/CF Avg High	36.8	30.6	
P/E Avg Low	24.8	22.3	21.6
P/E Avg High	44.4	36.6	
P/S Avg Low	7.4	6.29	6.8
P/S Avg High	13.4	10.22	
P/BK Avg Low	6.3	5.7	7.5
P/BK Avg High	11.4	9.5	

Internet. Ultimately in 2002, Microsoft signed a consent decree in which it promised to not design operating systems, software or Internet tools that excluded competitors' products or services and thus discouraged competition. However, competitors, the latest of which is Google, continue to claim that Microsoft seeks to impede them.

The same regulatory theme has played out in Europe and in Asia. We do not think Microsoft is seriously menaced by such scrutiny. As for lawsuits, they run both ways: Microsoft is sued and sues. Again, we don't think these will have a serious impact on Microsoft's future.

SHAREHOLDER VALUE

In the now discredited "New Era," the idea that a tech company would pay a dividend was heresy, since any growth company had better things to do than divert money that could fuel further growth into the pockets of shareholders. Microsoft reconsidered that model, and with \$49 billion in cash on its balance sheet in 2003 began to pay a modest dividend that today offers a yield of 1.3%. Microsoft without any long-term debt remains a cash machine, generating huge amounts of free cash flow, which management is using in a massive share buyback program. Last year, MSFT authorized and completed a \$20 billion buyback that shrank the company by 1.5%, and has earmarked \$36.2 billion more, of which a third has since been spent. Buybacks have a positive impact on shareholder value as do dividends except unlike with dividends there are no immediate tax consequences for shareholders. Now that Microsoft has ceased relying on options to reward employees and is using actual shares that vest over time, buybacks really are contributing to shareholder value rather than

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a way to balance out shares created as options were exercised.

VALUATIONS

At *Sound Advice* we're most comfortable with a stock's valuation when it falls at the low end of its historical range. Though past performance is no guarantee of future results, looking at where the market in the past has decided earnings, cash flow, sales and book value for a specific company are too cheap to not own has served us well.

Microsoft now fits that description, though as we note when discussing any stock whose price and valuations went sky-high during the tech bubble, such comparisons are not straightforward. In Microsoft's case, it traded in 1998 and 1999 at an average Price/Earnings of 64, a Price/Sales of 22.6, a Price/Cash Flow of 45.6,

and a Price/Book of 17.1, which in those happy days seemed not to strike Wall Street as bizarre. Based on MSFT's valuations between 1991 and 2006, today's price ratios are inviting, and even if we exclude the bloated valuations for 1998-2000, the numbers remain attractive as the table on the previous page shows. Price to Earnings and Price to Sales fall below or close to the average lows regardless of whether we exclude 1998-2000, current Price to Cash Flow and Price to Book fall somewhere between the high and low averages regardless of how we deal with that three year aberration. MSFT has come off the bottom it hit last June as investors anticipated Vista and Office 2007.

Provided the global economy does not crater—not something we see on the horizon—MSFT already has the goods to prosper. If Internet advertising kicks in, we now have a window of considerable opportunity. Buy MSFT up to \$34. **SA**

PORTFOLIO UPDATES

The *Sound Advice* portfolio since the May letter added 2.6% on a total return basis, while the Dow climbed 2.8%, the S&P 1.8%, and the Nasdaq 2.1%. Driving our performance was the surge in energy prices. West Texas crude oil closed on June 15th at \$68 a barrel, while natural gas (Henry Hub) stood at \$7.58.

The May recommendation, **Insituform**, ended up 3.1% without any positive news, a move that implies we've seen a bottom for the shares after the miserable quarterly numbers that preceded its entry into the portfolio. For several reasons, we think INSU is comparable to **Tetra Tech**. Both are plays on water-related infrastructure—with much of INSU's potential in this area tied to its Blue Water business, which is just getting started, and both hit bottom just as each had jettisoned money-losing businesses. INSU has a tougher task, since its revenues and profits depend on the willingness of politicians and bureaucrats, whose instinct is to ignore infrastructure problems as long as possible, to deal with the serious deterioration of sewage pipelines across the U.S. and internationally. No catalyst is evident, but the trick to bagging excellent returns is to buy solid companies cheaply when investors don't have a clue to how they will recover. That's why they are cheap.

Tetra Tech, which added 9.1% hitting levels not seen since the start of 2004, is showing plenty of catalyst, and has contracted to help construct two desalination

plants in Orange County (Southern California): one for Huntington Beach that will produce 50 million gallons or 7% of the county's potable water needs, and another, already under construction, will generate 70 million gallons per day to replenish exhausted ground water. In a recent interview, the CEO pointed out that his biggest contracts now are with U.S. government agencies concerned with securing our water supply.

ENERGY AND NATURAL RESOURCES

EnCana led the portfolio with a 16.5% move, **Transocean** 14%, **Royal Dutch** 10.5%, and **Icon Energy Fund** 8.7%. **Agrium**, because its feedstock for nitrogen-based fertilizers is natural gas, more firmly than ever belongs in the energy group, since the rush higher for the shares of fertilizer companies is tied not just to global demand for food but even more pointedly to recognition that farmers in the U.S. are planting corn for ethanol where they previously planted other crops. Growing corn depletes the soil more than do many other cash crops, hence the need for more fertilizer. AGU leaped 14.3%. We had some high volatility days for energy lately driven primarily by events, but the real news is that investors appear to be rethinking price ratios for energy-related stocks. Ever since oil bottomed around \$10 a barrel and began its march to current prices, Wall Street, adamant that energy would reverse, refused to

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reconsider its valuations. Perhaps now, as oil sits at \$68, that skepticism about energy's staying power is diminishing. Energy futures, for example, show expectations for higher prices as far as the eye can see.

In fact, natural resource stocks of all types are on fire.

Anglo American added 8.7%, and **Plum Creek**, the timber and land company, 7%. Only precious metals did not join the party, which is perplexing given how

inflation concerns again are infiltrating not just our own economy, but, it seems, the entire world. Nonetheless, **American Century Global Gold Fund** and **Coeur d'Alene**, the silver miner, which is working through company-specific problems, declined 5.7% and 3.7% respectively. The ironic explanation for falling gold and silver prices despite interest rates rising could be the support higher U.S. interest rates generate for the dollar, which in turn undercuts precious metals. We're content to increase our

exposure to precious metals, since we expect that at some point rising U.S. interest rates will cease to prop up the dollar.

Mattel, the toymaker, had a rocky month, dropping 11% for no other reason it seems than profit-taking after it had done nothing but go straight up since mid-2006. We still like MAT's product line and prospects.

When introducing **Wal-Mart** 12 months ago, we compared its ability to recover its reputation as a stock to own by comparing it to **McDonalds**, which when we recommended it had been designated a has-been, as WMT is today, bloated, ineffectively managed, and dead money. Some of the strategic moves that propelled MCD to giant gains are emerging at Wal-Mart. The recent announcement that Wal-Mart will slow its store expansion reversed recent weakness in the shares, and added 2.6% for the month. A mammoth buyback, which we think is a better use of money previously earmarked for store expansions in the U.S., also is helping the shares. Whether other decisions can reinvigorate the world's largest retailer is yet to be determined, but WMT is too big an asset to languish forever. As for McDonalds, the good news keeps on coming. In response to May sales that zoomed 7.4% in the U.S., 8.9% in Europe, and 10.2% in other regions (Asian, Pacific, African and Mideast) for stores opened more than a year, MCD added 4.6%. At this point, we are bidding the Golden Arches a well-earned farewell. The recovery story anticipated in our original recommenda-

tion has come to pass. It's time to look for something cheaper.

We're reading about how manufacturers won't pass on their increasing production costs, everything from energy to labor, but we wonder how that fits with rising share prices for food manufacturers? **Sara Lee** since the last letter is up 7.8% on very encouraging sales and profits news for the previous quarter. Each of the six

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divisions showed improved sales and earnings with particular strength in international beverages, household and body care, and North American meat sales. International sales benefited from the weak dollar. The balance sheet also is looking much better. For the first time since writing about SLE, we are starting to see positive results from the major overhaul imposed on what was a sprawling consumer conglomerate that derived more of its revenues from apparel than from its traditional identity as a food company. We expect more. **ConAgra**, another consumer food company that had fallen on hard times, last year burst out of the morass it had shared with Sara Lee, but has been quiet so far in 2007. It also enjoyed a good month, up 4.6% after saying its outlook for the year had improved even though its Peter Pan peanut butter division, which had average annual sales of \$150 million, has been shuttered until salmonella problems are resolved. **Coca Cola Enterprises**, the world's largest bottler and distributor of Coke products, is also doing well, up another 3.2% and 13.2% for the year. Coke, itself languishing for years, is adding new products beyond carbonated beverages, which is good news for CCE, its biggest bottler and distributor. Coke also is treating its bottlers better. Finally, CCE is starting to see benefits from realigning its organization and cutting headcount.

It was not all beer and skittles for every consumer company. **Molson Coors**, which is having a very good year (up 20.7% in 2007), dropped 4.7%, though that

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Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$11.08	7.58%	\$13.00	BUY
Senior Housing Properties	SNH	NYSE	\$24.05	5.65%	N/A	SELL
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$42.35	0.26%	\$47.00	BUY
American International	AIG	NYSE	\$72.58	0.69%	\$75.00	BUY
Boston Scientific	BSX	NYSE	\$16.41	0.00%	\$18.50	BUY
Coca-Cola Enterprises	CCE	NYSE	\$23.01	1.04%	\$24.00	BUY
ConAgra	CAG	NYSE	\$25.80	2.79%	\$29.00	BUY
CSX Corporation	CSX	NYSE	\$45.11	0.89%	\$51.00	BUY
Disney	DIS	NYSE	\$34.49	0.90%	\$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$48.65	1.17%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	\$60.31	0.80%	N/A	BUY
Fastenal	FAST	NASDAQ	\$42.19	1.00%	\$44.00	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	\$17.86	0.00%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$24.96	0.56%	N/A	BUY
Getty Images	GYI	GYI	\$49.77	0.00%	\$56.00	BUY
Honeywell	HON	NYSE	\$58.91	1.54%	\$59.00	BUY
Insituform Technologies	INSU	NASDAQ	\$19.93	0.00%	\$23.00	BUY
Johnson & Johnson	JNJ	NYSE	\$62.72	2.39%	\$69.00	BUY
Liberty Capital	LCAPA	NASDAQ	\$119.00	0.00%	\$125.00	BUY
Mattel	MAT	NYSE	\$25.81	2.52%	\$32.00	BUY
McDonald's	MCD	NYSE	\$52.24	0.44%	N/A	SELL
Microsoft	MSFT	NASDAQ	\$30.49	1.31%	\$34.00	BUY
Molson Coors Brewing	TAP	NYSE	\$91.90	0.89%	\$100.00	BUY
Newell Rubbermaid	NWL	NYSE	\$29.40	2.86%	\$32.00	BUY
New York Times Co.	NYT	NYSE	\$25.86	2.71%	\$27.00	BUY
Perrigo	PRGO	NASDAQ	\$19.77	0.91%	\$23.00	BUY
Sara Lee	SLE	NYSE	\$17.91	2.23%	\$20.00	BUY
Schering-Plough	SGP	NYSE	\$31.02	0.71%	\$37.00	BUY
Sony	SNE	NYSE	\$54.53	0.39%	\$59.00	BUY
Sprint Nextel	S	NYSE	\$22.07	0.45%	\$24.00	BUY
Superior Industries	SUP	NYSE	\$22.49	2.85%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$22.41	0.00%	\$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$64.58	5.17%	N/A	BUY
United Parcel	UPS	NYSE	\$74.08	2.05%	\$82.00	BUY
Wal-Mart Stores	WMT	NYSE	\$49.31	1.36%	\$52.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$62.38	3.16%	N/A	BUY
Xerox	XRX	NYSE	\$18.86	0.00%	\$21.00	BUY
Energy/Natural Resources						
American Cent. Gold Fund	BGEIX	800-826-8323	\$18.57	0.27%	N/A	BUY
Anglo American PLC	AAUK	NASDAQ	\$31.22	1.81%	\$36.00	BUY
Coeur d'Alene	CDE	NYSE	\$3.69	0.00%	\$4.00	BUY
EnCana	ECA	NYSE/TSE	\$65.67	0.91%	\$75.00	BUY
Icon Energy Fund	ICENX	800-764-0442	\$39.61	8.48%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$42.79	3.74%	\$46.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	\$79.07	3.10%	\$84.00	BUY
Transocean	RIG	NYSE	\$102.93	0.00%	\$110.00	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	\$27.99	0.00%	\$30.00	BUY
Crescent Real Estate	CEI	NYSE	\$22.32	6.72%	N/A	SELL
Discovery Holdings	DISCA	Nasdaq	\$24.20	0.00%	\$27.00	BUY
Electronic Data Systems	EDS	NYSE	\$27.87	0.72%	\$30.00	BUY
Liberty Global	LBTYA	NASDAQ	\$39.31	0.00%	\$42.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$32.85	1.89%	\$35.00	BUY
Mitsubishi UFJ Financial	MTU	NYSE	\$11.67	0.81%	\$16.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$5.67	1.76%	N/A	BUY
Symantec	SYMC	NASDAQ	\$19.69	0.51%	\$22.00	BUY
Time Warner	TWX	NYSE	\$20.88	1.05%	\$24.00	BUY
Western Digital	WDC	NYSE	\$19.76	0.00%	\$20.00	BUY

*Prices as of the market close on Friday, June 15, 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 Market Indicators

might reverse if recent comments by the CEO of SABMiller, the parent of Miller Brewing and a slew of other brands accumulated through aggressive acquisitions, is more than just idle chatter: the CEO thinks highly of TAP, and “Should they make themselves available ... clearly we would look at everything out there.” TAP on that news bubbled up to pennies below \$100 before settling back. We’ll see. When Coors first came into our portfolio, it was considered far weaker than Anheuser Busch, yet over the last three years, as TAP grew by 53%, the far larger and better respected BUD has gone absolutely nowhere. Sometimes it pays to buy the underdog rather than the best of breed.

REITS

Real Estate Investment Trusts should enjoy an advantage over bonds during a period of inflation-driven rising interest rates. Provided they are able to continue to raise their rents, REITs can increase their distributions. Most debt-instruments have a fixed coupon. However, the immediate response from investors to rising rates has been to dump REITs, something we had been doing as their portfolios began to be valued by Wall Street at premiums to what we calculated them to be worth.

We see no reason to swim against this particular tide, especially because REITs’ appeal for the moment appears to be solely to private buyers. We are selling Senior Housing Properties Trust (-6.3%), and also recommend selling Crescent, which added 8.6% thanks to a private buyout offer from Morgan Stanley. The only reason to hold CEI would be anticipation a richer offer might emerge. We doubt that. We retain **HRPT Properties Trust**, since by our calculations HRP remains underpriced based on its rich Funds from Operations. HRP dropped 8.3% regardless of its real-world value. We will wait to reload our REIT portfolio until portfolio values realign with share prices.

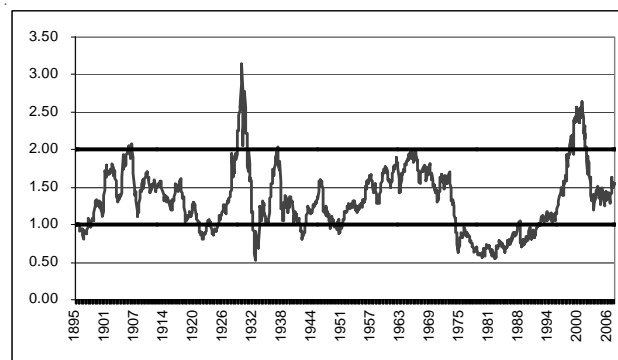
Discovery Holdings, a mixed bag of assets spun off from **Liberty Media**, keeps charging higher, adding 10.2%. In May, DISCA announced it would close its 100+ retail stores, a money loser, to concentrate on its rich media properties. **Sprint Nextel** is buying up some affiliates. Investors also are taking a more positive view of WiMax, the technology on which Sprint is betting heavily. The shares closed out the month up 6.8%, and 22% since its February introduction. Keep an eye on **Boston Scientific**, up 1.6%, which remains widely unpopular but is slowly digging out from under the mountain of bad news that preceded our buy-in. **SA**

The Sound Advice Market Indicators:

The Risk Indicator (shown to the right) tracks supercycles in stocks by comparing prices of stocks to real estate (house prices). A reading above 2.0 indicates times when stocks are extremely high relative to real estate. These are times when the risk is high and a supercycle is approaching a zenith. Conversely, a reading below 1.0 indicates stock prices are extremely low relative to real estate. At these times, the upward phase of a new supercycle is beginning. The current reading stands at 1.54, unchanged from last month's reading.

We recently updated the adjusting factors to make this indicator more useful. The new adjusting factors are explained in the 2007 edition of *A Millionaire's Guide to Panic-Proof Investing in the Stock Market*. We send this book with renewals on a complimentary basis. If you have a red alert above your address, this book will be included with your renewal. If your subscription is not up for renewal for several months, please call our office to receive a complimentary copy.

Within the span of a supercycle, there are usually several business cycles that cause the smaller up and



down markets we refer to as bull and bear markets. When the Risk Indicator is moving higher from 1.0, we are in the upward phase of a Supercycle. During the upward phase of a supercycle, bull markets will be more energetic than bear markets. During this upward phase, bull markets can become so strong that they can carry the Risk Indicator well above 2.0. This happened in the late 1920s and the late 1990s.

The reverse is true during the downward phase of supercycles. When the Risk Indicator is moving down-

Sound Advice Market Indicators

ward from 2.0 toward 1.0, bear markets will be stronger than market prognosticators project, while bull markets fall short of expectations.

The Diffusion Indexes

Because bull and bear markets are governed by business cycles, it is therefore critical to track business cycles, which is what our Diffusion Indexes are designed to do. Regardless of how many bull and bear markets may occur in a supercycle, it is also important to take a lesson from history by observing that a supercycle always peaks along with the current business cycle; and it also bottoms along with the current business cycle.

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. **Based on data for April 2007 we have a BUY Signal as all indicators fell to zero.**

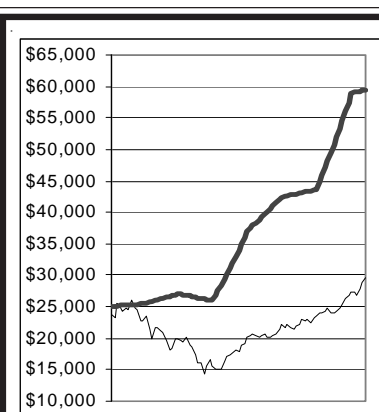
The Diffusion Index of Lagging Indicators gives “sell” signals when all five of its lagging economic indicators rise above their respective levels of six months earlier. This reveals a strengthening economy and inflationary pressures ahead. **Currently, 37.5% of its lagging indicators are above their 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. We will be looking for special situations and are likely to recommend taking profits more readily. Conversely, during “buy” signals, our recommendations will be more aggressive.

The latest signal came from the Diffusion Index of Leading Indicators, a 100% reading in June 2007. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market averages. The chart below shows how *Sound Advice* recommendations have performed versus the S&P 500.

History of the Signals

- * **October 1968, SELL:** At the zenith - the market plunged by 25%.
- * **May 1970, BUY:** Near the beginning of the new bull market.
- * **May 1973, SELL:** Just prior to the 50% plunge.
- * **December 1974, BUY:** Announcing a new bull market.
- * **August 1977, SELL:** After a 25 percent gain.
- * **November 1979, BUY:** Announcing another bull market.
- * **January 1984, SELL:** After a 70% gain.
- * **September 1984, BUY:** The market subsequently doubled.
- * **September 1987, SELL:** One month before the Crash of 1987.
- * **March 1988, BUY:** The market rose 34%.
- * **September 1989, SELL:** For a sideways market.
- * **January 1991, BUY:** The market climbed 52%.
- * **March 1995, SELL:** For a short breather.
- * **July 1995, Buy:** For a 154% gain.
- * **May 2000, SELL:** Two months from the peak and a 40%plunge.
- * **February 2003, BUY:** The month the market bottomed.
- * **October 2005, SELL:** After a 48% advance.
- * **June 2007, BUY:** The last signal to date.



Sound Advice versus the S&P 500

An Investment of \$25,000 becomes:

Start Date	S&P 500		Sound Advice*		
	Annual Return		Annual Return	Advantage Over S&P	
From 1/1/2006	\$30,962	17.4%	\$33,845	23.7%	\$2,276
From 1/1/2003	\$46,378	15.4%	\$56,875	20.4%	\$9,588
From 1/1/2000	\$28,942	2.2%	\$59,493	12.3%	\$29,984

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

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