



Savers are being pushed to extinction by the current interest rate environment, which only got worse as the yield on 10-Year Treasuries last week fell under 3% again. As recently as last April, the yield on the 10-Year was 3.6%. If you could find money at less than that, oh, say 0.25%, you could make 3.35% on your trade. And if you could borrow even more to leverage that trade, oh, say at a 10:1 ratio, you could make some serious profits. Of course, neither you nor I can borrow at 0.25% but if you are a bank, the Federal Reserve is prepared to ship you all you want at that price. Given that the unadjusted rate of core inflation is running at 3.2%, money at the Fed Funds rate is literally free.

During the tumult in 2008 as Bear Stearns fell, Lehman Brothers went BK, AIG became a government ward and Wall Street waited to see which investment bank would collapse next under the weight of its derivatives, Goldman, Morgan Stanley and several other Wall Street firms converted their status from investment to commercial banks, which among other things allowed them to borrow at extraordinarily cheap rates directly from the Federal Reserve. These new banks, with their balance sheets in tatters, immediately borrowed tens of billions to prop up their compromised balance sheets and to generate some income. Effectively the Fed in that crisis found another way to subsidize the new banks.

OK, the banking crisis has subsided, but the Fed is still subsidizing the banks by letting them capture the spread between the Fed Funds rate and longer-duration Treasuries' yield. If the stated purpose of maintaining low interest rates is to encourage borrowing by companies and consumers, why is so little credit getting into the economy? For one thing, borrowers remain skittish about new debt. But that's no problem for the banks. Rather than expose themselves to the risk of lending to businesses and consumers, these new Wall Street banks instead are borrowing from the Fed at 0.25% and then buying U.S. debt from the Treasury. From the perspective of the Treasury and the Federal Reserve, this is an expensive way to find buyers for U.S. government debt, but from the perspective of the banks, this is a perpetual profit machine. From the perspective of the tax payer, what ever happened to capitalism?

-Gray Emerson Cardiff

## Time To Sell?

We are back in what *Sound Advice* considers another correction in an ongoing bull market, so the answer to the question is "No." Whether events confirm that view, as they have repeatedly over the last two years since we decided it was time to get more aggressive in the March 2009 issue ("Approaching A Buy Signal"), remains to be seen. We adhere to our diffusion indexes, which triggered that spring 2009 call to buy. They continue to tell us that because there is more room for the economy to improve, there is more room for stocks to rise.

Our asserting what our indicators dictate is hardly informative, so it's worth looking at the components of the diffusion indexes, both for the Leading Indicators, which we use as our Buy Signal, and for the Lagging Indicators, which we use as our Sell Signal. For background, we suggest you look at *The Science of Making Money in Turbulent Markets*, which you received as part of your subscription.

Keep two things in mind. First, these indicators are all based on the economy and rely neither on technical market data nor investor sentiment. Second, we see economic conditions from a contrarian perspective. In the World According to CNBC, bad economic news encourages selling and good economic news buying. *Sound Advice* reverses that: the best time to invest is when the economy is at its weakest, since that coincides with poor corporate earnings, investor fear and disgust with equities. The best time to get more defensive is when the economy is humming, which coincides with strong earnings, market enthusiasm and persistently higher share prices.

The Diffusion Index of Leading Indicators includes four data points: average initial claims for state unemployment, building permits for new housing units, index of supplier deliveries and the spread between long term Treasury Notes and the Federal Funds Rate. When each reflects worse conditions (higher unemployment, fewer building permits, quicker deliveries and a narrowing spread) than existed six months before, we have a Buy Signal. In the May data, only building permits were below where they stood six months ago. Unemployment was just 50,000 less (0.1%) than in November.

However, the Buy Signal's components are less important now than are the Sell Signal's, which came close to being triggered last November when only the consumer credit number fell short. The other two components are average duration of unemployment and the Consumer Price Index's service element. Duration of unemployment now is strikingly bad, 13% higher than six months before. It will take a dramatic change in job creation to reduce unemployment duration to have it support a Sell Signal. The CPI component is well above where it stood six months ago, while the consumer credit number is modestly (1.6%) away from contributing to a Sell Signal.

We appreciate that remaining in the buy mode is unnatural given the gloomy economic data, but that is how we have outperformed over the years. To change now makes no sense. **SA**



## Can Tellabs Connect?

During the tech bubble years, *Sound Advice* shunned technology stocks because their shares for us were way too expensive in terms of sales, cash flow, earnings and book value. We lost some subscribers after noting in passing that Cisco, then in the mid-\$70s, according to our back-of-the-envelope calculation, would be worth buying in the mid-teens. Indignant calls followed, the gist of which was that if we didn't understand why Cisco would shoot even higher, we certainly were not qualified to give investment advice. As it turned out, Cisco bottomed in October 2002 at \$8.60, which along with the rest of the Nasdaq finally represented a real bargain. Today CSCO trades at \$16, still 80% below the shares' all-time high. In the April issue, again in passing, we mentioned Cisco as worth buying today. We still think so. In fact, we gave serious consideration to recommending Cisco but instead decided to look elsewhere in the telecom hardware sector and have settled on an even more beleaguered company, **Tellabs (TLAB—Nasdaq)** that presents a seductive combination of valuation and prospects for recovery. In addition, the balance sheet not only is free of debt, it also has in cash and marketable securities more than half the value of the current share price. It even pays a dividend (1.9%).

Whereas revenues for Cisco, an \$88 billion market cap behemoth, for the past year were \$42.9 billion, Tellabs with a market cap of \$1.6 billion had revenues of \$1.6 billion. That sort of disparity, one attractive stock trading at a price/sales ratio around 2 and the other at 1, catches the attention. However, anyone familiar with Cisco and others in the telecom hardware sector is unlikely to be too excited by that comparison, since many of the big cap names have lagged the overall market and the tech-centric Nasdaq over the last decade. Low valuations are common. Tellabs' valuations just happen to be among the lowest.

Yes, there have been some winners this year in the telecom hardware sector such as Alcatel-Lucent, JDSU and Polycom, but a broader gauge, the iShares S&P North American Tech-Multimedia Network ETF (IGN—NYSE) tells a clearer story: it is flat and the most prominent name, Cisco, is off 20.9%.

### Telecom

As with any investment there are company specific and sector issues to consider. Across the sector, customers either are buying cheaper products with modest margins or are willing to pay premium prices for the most advanced hardware. Price competition among vendors, both domestic and also international (especially Chinese) is also putting pressure on margins for the cheaper units. Demand is also a mixed picture. Though private clients in the enterprise sector, that is, non-telecom companies, are increasing their budgets for networking equipment, government, especially at the state and local levels, has tightened its belt and is deferring

purchases. As for telecom companies, the biggest end users are under extreme pressure to extend and deepen their networks to meet an insatiable demand for new bandwidth. However, consolidation among telecom companies has reduced the number of buyers, which in turn has left equipment makers vulnerable to their customers' ability to dictate prices.

This is why many telecom equipment stocks broadly speaking have lagged not just other technology names but the broader market. And even among the exceptions that have prospered, should one stumble, as did F5 when it missed analysts' projections last December, they get pole-axed. The sector is seen as hazardous.

### Demand

The last time we saw helter-skelter infrastructure telecom expansion was during the tech bubble years of the late 1990s. Equipment companies couldn't churn out equipment fast enough to satisfy anticipated demand from existing telecommunication companies and from upstart rivals that were laying fiber optical cable as fast as they could dig the ditches. The Internet had changed the world, and as everybody "knew," bandwidth demand, depending on which authority was pontificating, was doubling every 3.5 months, or every 8 months, or every 11 months, or according to the most conservative projections, every year. When the party ended, not only had many of those Internet companies like Pets.com, or Webvan.com, or theGlobe.com that were supposed to generate Internet traffic failed, there also was a glut of unused capacity, because, as it turned out, capacity projections had been made by companies like WorldCom and Enron, which to puff up their stock prices had been fabricating not just their accounting but the realities of demand.

As it turned out, no one really knew how much demand there was, but it certainly wasn't doubling at even the most conservative rate. In fact, in 2000 there was a glut of bandwidth capacity that was left dark for several years. The only winners were shrewd entrepreneurs who bought up that excess capacity on the cheap (**Leucadia** made a killing doing that), and sold it off over the following years as real demand grew.

Today we're seeing another rush for bandwidth but this time there's no need for hype. This time the drivers are not just the popularity of digital devices but what they can do. Back in the late 1990s most digital demand came from desktop PCs and laptops that were used for email and other Internet functions and data transfer through hardwired lines. Cell phones added to demand but were used almost entirely for voice communication.

Fast forward to 2011 and in addition to those old school units and purposes, we have an array of mobile devices that can

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do almost everything desktops can do. Furthermore, there are new uses, especially streaming video that range from homemade two minute clips on YouTube to feature length Hollywood films from Netflix. Slowly Internet TV is beginning to soak up significant amounts of bandwidth. Consumers are viewing these things on hardwired computers but more and more they want to do it on the go, using their smart phones and tablets. Telecom service providers are only too happy to cater to that demand. What comes next is limited only by creativity. It's a race among telecom companies to keep ahead of demand, since whichever one can provide service everywhere and provide it without pauses as packets of data move from their servers to your device will attract subscribers.

### Drivers

Telecom equipment spending peaked in 2007-2008 as projects begun during the economic expansion were being completed. Then in 2009 and 2010 as enterprise (both government and private sector) and telecom service companies tightened their belts, hardware sales withered. For example, Verizon, after increasing capital expenditures by double-digits from 2004 through 2006, reduced to 4% growth in 2007 and then, as the economy slowed, cut back modestly for the following three years. This year Verizon is on schedule to increase cap ex by 3%. Standard & Poor's projects that over the next three years global market for telecom equipment will bill out at about \$250 billion annually. In addition to private sector expansion, despite local governments retreat, Washington has budgeted \$7 billion to bring fast broadband to every corner of the U.S., a 21st century equivalent of the 1930s' rural electrification project. Similar government sponsored expansions of broadband, as we're seeing with [Telecom New Zealand](#), will spur demand even more.

If expenditures are ramping up again, their focus has shifted away from wireline (mostly fiber optic) projects to wireless network expansion, since this is where the greatest demand is. Cisco estimates that global mobile traffic is growing 2.4 times faster than wired broadband traffic. Cell phones have penetrated 96% of the U.S. population and 73% worldwide. But that really isn't the story.

IDC, a market survey company, estimates that manufacturers shipped 99.6 million smart phones during the first quarter of 2011, a 79.7% year-over-year increase. This year expansion will slow to "just" 49.2%. Today about 25% of phones are considered "smart." Within five years that portion is expected to triple. Of even greater significance for telecom companies, the number of applications downloaded by smart phone owners in 2010 hit 10.9 billion and is projected to boom to 76.9 billion by 2014. Depending on how thirsty the app is, each requires significant bandwidth. Tellabs estimates that the average smart phone consumes ten times the wireless traffic than does the average wireless phone.

Then there are tablets like the iPad and their passive siblings, readers like the Kindle and the Nook. All soak up prodigious amounts of bandwidth. Beyond these hungry devices are computerized vehicles that require wireless communication, mobile gaming and medical data is being transmitted through wireless devices. Finally, the growing dependence on cloud computing, that is, the replacement of locally kept software

and data by applications and data stored elsewhere and accessed through the Internet, whether by wire or wireless, is putting an entirely new demand load on telecom service providers. All of this points to an urgent and persistent need to expand telecom infrastructure around the globe. There is no doubt that telecom companies must dramatically expand their capacity, especially for wireless. Though there is a place even for hardware companies that produce commodity-type units, suppliers that can provide innovative, cost-effective products will prosper.

### Tellabs

Tellabs' problem is that most of its current products, though still in demand, are not cutting edge. As the CEO, Rob Pullen, put it in January: "So where is Tellabs today? We are managing a core business in secular decline... That's also as we nurture the growth of new and more global business."

Tellabs has been producing hardware for the telecom industry since the mid-1970s, and along with its competitors during the late 1990s enjoyed bubblicious growth, hitting \$77 a share in 2000 that translated into a Price/Earnings ratio of 46, a Price/Cash Flow of 39, a Price/Sales ratio of 9.5 and a Price/Book ratio of 12—numbers that will never be seen again. We are now at the opposite end of that spectrum with TLAB trading at minuscule levels never before seen in the company's history.

Since the 2000 frenzy died, Tellabs has had to deal with two recessions, which killed sales but also has seen business migrate to companies with more innovative products. Aside from rigorous cost cutting, which continues, management during the last decade sought to diversify its customer base by cultivating international sales and has tried to move into other areas of telecom such as broadband local access. International sales have proved fruitful. Indeed, were it not for foreign customers developed over the last decade, Tellabs' current situation would be worse. However, initiatives to find revenues from new sources such as the acquisition of Advanced Fibre Communications (2004), whose products connect telephone companies to homes and businesses, did little to reverse the company's decline. But in 2009 Tellabs did make a deal that does look like it can change its fortunes when it acquired WiChorus, which develops products dedicated to the next generation of wireless communications: 4G such as WiMax and LTE. WiChorus technology underpins where Tellabs intends to market in the future. If Tellabs successfully can build its new platforms on WiChorus' technology, revenues and profits will return.

### Falling Shares

Over the last year, Tellabs' poor quarterly results have triggered huge drops in the share price as investors threw in the towel. Thus, last October with the share price above \$8, after projecting lower sales figures for the coming quarter, TLAB plunged 13%. In January, after another dispiriting quarter, the shares fell 19%, the biggest single day fall in a decade. After the April 25th conference call, the shares dropped another 9%. In total, since the eve of the October conference call, Tellabs' share price has fallen from \$8.06 to \$4.43, a 46% drubbing. This year, TLAB is the S&P's worst

performing member, down 36%.

Revenues in Q1 were 15.1% below the same quarter in 2010 and that profits went from 12 cents last year to a seven cent loss. No segment of the business from hardware to services did well. Furthermore, gross profit margins collapsed from 54.4% to 41.4% as the company pushes to develop new higher-margin products but sold more lower margin optical networking equipment and had to absorb the loss of much of its sales to AT&T (35% of revenues last year), which along with Verizon, had accounted for 55% of revenues.

When companies suffer such losses, conference calls following a poor quarter's performance can get testy. Two exchanges in the April 25th conference call reflect this. One analyst asked why Tellabs, given its strong cash position and how cheap its shares had become (at the time they were trading at \$5.47), was not aggressively buying back its shares, especially because, the analyst assumed, Tellabs had been approached by buyers who naturally would be willing to pay a premium above where TLAB shares traded? In short, if Tellabs is such a bargain now, why not take advantage of that opportunity by snapping up your own shares?

The CFO responded by saying that over the last five years the company had bought back \$1 billion worth of its shares using free cash flow, but that in the last quarter, since there was no free cash flow, no purchases were made. Tellabs decided it was more important to have cash on hand to fund research and remake the company than it was to dip into its liquid assets to support the shares.

The next questioner was even more pointed: "Why aren't you guys more committed to getting profitable? And I mean, with 38% gross margins, you should be much higher than breakeven profitability over the near term, why isn't that a near-term commitment? And given the stock price underperformance versus your comps, how have you guys failed in your execution? I want to have a better understanding that there's realization that you guys have done a poor job executing, and I want a better understanding of what you're doing differently now to correct that."

It doesn't get much more uncomfortable than that for a CEO, but this really focuses the issue for Tellabs. Can shareholders absorb current pain as evidenced by lower sales highlighted by the loss of AT&T's business, even lower profits and a lack of strong products that could command higher margins while management remakes the company? Pullen responded: "Look, we didn't execute with a big customer in North America. They selected the biggest vendors in the world to work in the domains and we needed a next generation platform that we didn't have yet that we're working on now, which is why we're investing for our future. We'll improve that over time."

And that is the question *Sound Advice* faces as well. The most encouraging evidence is that Tellabs is pouring money into Research & Development. Despite slipping sales, the company has earmarked 25% of that income to bringing new products to market. In fact, had the company pared back its R&D budget, it would have turned a profit for the last quarter. That it chose not to is a good sign. Furthermore, Pullen, who

had been with Tellabs since the early 1980s, is an engineer who understands that products come before marketing. If anyone can get Tellabs back to being an industry leader, we think Pullen is it. He is also making sure that money is spent on core purposes. He's outsourced production and keeps doing more with fewer staff. About 40% of Tellabs' employees are in R&D.

We recognize the high-stakes nature of the telecom hardware business, but believe that Tellabs is capable of developing products that will regain market share. But frankly, we also recognize that Tellabs could remain in revenue limbo for an extended period. Should that occur, we suspect the aggressive questioner's implied outcome, sale of the company, might occur. In that case, we believe that a buyer would pay a significant premium for Tellabs. To better appreciate how cheap TLAB is today, let's look at its valuations.

### Cheap is Cheap

Numbers reported at the end of April for Q1 were dismal: cash flow was negative, when compared to the same quarter in 2010 revenues were down 15% and earnings went from 12 cents a share to a loss of seven cents.

If we look back over the last 23 years and calculate valuations at the shares' highs and lows each year, we can get a sense of how much or little investors have been willing to pay for Tellabs. Admittedly this includes the bubble years as well as depressed periods such as 2001-2003 and 2009-2010. Price to Sales over the last 23 years, which includes the bubble years when the ratio ran as high as the low teens, has had an average historical low of 2. Currently P/S stands at 1.07. Price to Cash Flow over the same period has averaged at its high 33.8 and at its low 14.2. Currently P/CF is 11.7. As for Price/Book Value, historically it has run as high as 12 (2000); its average high has been 5.3 and its historical low average has been 2.8. Currently it's 0.9. Price/Earnings, the most commonly cited valuation metric, is not meaningful given the last two quarters' losses.

Even more startling is the balance sheet, which shows \$2.91 per share in cash and cash equivalents (short-term government debt or commercial paper) with no long-term debt. Other assets and liabilities on the balance sheet offset each other. Subtract that \$2.91 from the \$4.33 share price and you are buying the entire business for \$1.42. Admittedly we are gambling that Pullen can pull a digital rabbit out of Tellabs' hat, but the risk/reward ratio is excellent.

Tellabs goes into the Aggressive portion of the portfolio. We see two likely outcomes: a resurgence in sales and profits that will bring investors back to TLAB, or a sale of the company. Plan A requires Tellabs successfully to roll out new products that sell. But if Tellabs stumbles, we think the board of directors will start paying attention to acquirers who covet Tellabs' customers and even its hardware. What might that price be? Given the cash hoard and other assets and factoring in a takeover premium, \$7 or 60% higher than the current price sounds about right. Plan A, a recovered Tellabs, should be worth \$9 to \$10. We recommend an initial buy limit of \$5.50 **SA**.

# Portfolio Updates

For those who embrace “Sell in May and Go Away,” May played out fine. Since we priced the last issue on May 6th, the Dow is down 1.8%, the S&P 500 3%, the Nasdaq 3.4% and the pan-market Wilshire 5000 2.9% as Wall Street recoiled from successive waves of poor domestic economic news, the worst of which was the miserable May jobs report that rather than exceeding or even meeting the expected target of 140,000 fell to 54,000. The *Sound Advice* portfolio with dividends and distributions included dropped 2.6%. The May issue reviewed four funds in the existing portfolio: **Third Avenue Value Fund** (-1.3%), **Dodge & Cox International Fund** (-1.8%), **Dodge & Cox Stock Fund** (-2.6%) and the **USAA Precious Metals & Minerals Fund** (+0.5%).

That gold mining shares, which are at the core of USAGX, did not do better considering that gold itself was up more than 3% is a head-scratcher until you factor in not only that shares in gold miners move with the overall market but also reflect concerns about rising costs to exploit what these companies own. As for the Armageddon perspective that drives some during times of geopolitical unrest toward owning bullion rather than less tangible shares in mining companies, we shouldn't discount this either.

As for other natural resource positions, **Anglo American**, the mining holding company that does industrial metals and has no precious metals exposure, shed 2.7%. **Leucadia**, which is a holding company with diverse assets, often moves with industrial metals because of its significant exposure to copper and iron miners, fell 6.6%. **EnCana**, the Canadian natural gas company, added 2.6%. **Fidelity Select Natural Gas Fund** dropped 0.7%. Why the discrepancy? Though the FSNGX portfolio is weighted toward natural gas, many positions (Apache, Anadarko, Chesapeake) are also tied to oil, which did not do well over the last month. **Transocean**, which has been having problems not so much because of lingering anxiety over its liability for environmental damage from the BP oil spill in the Gulf of Mexico but because of concerns that the deepwater drilling business might cool from white hot to merely red hot, will make a \$3.16 distribution to shareholders of record on May 18th. The cash will be paid out in quarterly installments and at RIG's current price works out to a 4.6% yield. Even factoring in that dividend, the shares are off 0.3% since the last letter.

**Agrium**, a fertilizer manufacturer and distributor, added 2.8%. But Tetra Tech, which primarily in the water remediation business but also does engineering for wind power and energy companies, dropped 3.7%. New contracts continue to come in, but concerns over diminished government spending for water projects continues to cast a cloud over the shares. **Plum Creek Timber**, which is tied to construction and real estate, dropped 3.8%. As long as we continue to get bad news about the overhang of unsold homes, whether in some stage of default or foreclosure, or just being sold under normal circumstances, it will stumble about.

As investors fixated on whether the U.S. economy might be slipping into stagnation (and concerns that China, which is worried about inflation, might overtighten and suppress its appetite for commodities, cyclical stocks had a hard month.

**Superior Industries** had been riding high in the spring but has reversed course as concerns over weaker vehicle sales and rising gasoline prices tainted the auto sector. With a dividend over 3% SUP is worth buying here. **CarMax**, the used car chain, tumbled 12.2%. There's been some concern over an increase in funds reserved for bad loans, but we think the larger issue is whether the economy is slowing. Higher energy prices once again has shifted buyers' preferences away from SUVs and other large vehicles toward more fuel efficient units. This creates inventory and pricing problems for KMX. As with SUP, we view current weakness as an opportunity.

Lastly, **International Speedways**, which operates auto racing tracks across the country, is perhaps even more sensitive to how the economy, especially job creation, is doing, since its audience comes from blue collar, younger working men and women, who have been particularly hard hit by the recession and even now that the numbers say the recession is over conditions with 9% unemployment are still difficult. ISCA lost 5.8% since the last letter, though it remains ahead of the averages, up 8.3% year to date. Looming ahead is renegotiation for TV rights. The first contract, written in 2005 when NASCAR viewership was at its height, comes up for renewal in 2013. Viewership is down about 20% and investors are worried Fox will chop its payments. We expect the contract won't be far from current rates. Resolution of this issue will be a boost for the shares. Finally, management is expanding revenue from its properties by introducing new activities. The most prominent is a hotel/casino at the Kansas track that is scheduled to open next year and could add \$25 million to ISCA's operating profits.

**Paychex**, the payroll services company, focused on small to medium sized companies, has been milling around as the economy slowed. The job news hit the shares hard. Meanwhile, PAYX is bolstering its business, most recently by acquiring an Internet based ePlan, which provides administrative support to retirement plan companies. Since the last letter, PAYX has dropped 4.5%. We'd be accumulating shares here. Both **Fastenal** (note a 2:1 stock split), which supplies hardware, especially screws, bolts and other construction items, and **Honeywell**, which is everything from heating and cooling to aviation, both lost 5.2%. UPS, which is as close to being a surrogate for domestic and global commerce, lost 3.3%.

Not surprisingly healthcare on the whole fared better as money flowed toward defensive names. **Stryker** continues to bolt on acquisitions that deepen its strengths, picking

up Orthovita a maker of surgical products for fractures. SYK is up 0.9%. **Pfizer**, which when we recommended it last year was deemed a terrible investment because it was about to lose patent control over Lipitor, its flagship statin, continues to push higher, adding another 2.4% since the last letter (23.2% year to date and 34% since its 8/6/2010 recommendation at \$16.24). Pfizer has been adding new drugs, the latest of which, Crizotinib, has been given FDA expedited testing schedule. **Johnson & Johnson**, about whose missteps, especially in its consumer division, we've gnashed our teeth, is up another 2.1% on more positive news about its drug pipeline. For anyone who decided to swim with us upstream, JNJ's recovery since mid-March is 14.6% plus dividends, while the benchmarks are barely 4% higher. **Hambrecht & Quist Life Sciences Fund** complete its tender offer for shares and has readjusted to its diminished share count and the absence of that attractive offer. The shares are 1.3% lower since the last letter and the discount from NAV has expanded to 9%.

Two positions that have stormed higher this year gave back a bit since the last letter. **AHS**, the temp agency for nurses, doctors, pharmacists and other hospital staff, drifted 2.6% lower as concerns again arose over whether the U.S. economy was stagnating, which would reduce the likelihood full-time nurses might cut back hours or even retire. Note, however, that one of the only sectors of the U.S. economy to create jobs in May was healthcare, which suggests medical hirings cannot be postponed. This augurs well for AHS. The shares, since recommendation in February, have advanced 37.5%.

**UnitedHealth Group**, the HMO, slid 3.5% on no particular news, and remains 35.3% to the good for the year. The driver, aside from recognition that federal healthcare reform could help rather than hurt medical insurers, has been the poor economy that discourages those with insurance to seek treatment because they are reluctant to cover co-payments. Those with no insurance are postponing care as well.

And then there is **Boston Scientific**. In the May issue, the shares were up 9%. There was some good news and a sense that maybe the management team brought in to turn the company around two years ago finally was getting somewhere. Then the CEO, Ray Elliot, abruptly announced he was retiring at the end of the year, which suggested that perhaps the recovery was not progressing. In response, the shares fell 14% in less than two weeks, but recovered a bit to down 11%. BSX remains an aggressive investment, whose success depends in part on developing new products with high margins but also—perhaps to an even larger extent—to not tripping over its own corporate feet. We don't think that is too much to ask. We remain chastened optimists.

**Telecom New Zealand**, which last month won a significant share of the construction of a rural broadband upgrade got even better news when the Crown Fibre Holdings, the government entity overseeing the modernization of not

just rural coverage but the rest of the country, awarded NZT 24 of the remaining 25 ultrafast broadband contracts including key locations in Auckland and Wellington. On the news, NZT vaulted and since the last letter is up 12.8% since the May letter was priced, though as the U.S. dollar has regained a bit the shares lost a bit in translation.

REITs were mixed. **Associated Estates**, the apartment REIT, dropped 3.1% as REITs in general were under pressure. Given the very poor data on home purchases, we would have expected to see rentals remain strong, but when selling sets in, even appropriate investments can suffer. **Commonwealth REIT**, which owns mostly office properties and is more exposed than AEC to concerns about a slowing economy, dropped 2.7%. CWH will sell on June 1 a \$250 million cumulative preferred with a 7.25% yield. The proceeds will be used to reduce its revolving credit line and for acquisitions. **CGM Realty Fund** was up 0.3%.

Interest rates play a role with REITs and as those rates continue to drop, REIT yields become more attractive. With the 10-Year Treasury Note falling to 3%, a reflection of concern about economic recovery, the **ProShares UltraShort Lehman 20+ Year ETF**, which moves inversely to interest rates, dropped 3.7%. The **Powershares Senior Loan Portfolio ETF**, which is tied to floating rate high-yield bank loans, edged 0.5% down, while the **Third Avenue Focused Credit Fund** did the same. The bank loan portfolio should show the least sensitivity to changes in interest rates, since its yield resets in tandem with LIBOR. As for the Focused Credit Fund's portfolio of high-yield fixed-rate debt, its price is being supported by lower interest rates but challenged by a slowing economy, since high-yield (AKA "junk") acts more like equity than debt.

Our tech positions followed the Nasdaq lower. **Microsoft** made a generous bid to acquire Skype, the Internet communication system, in the hope that it could use this unique property to enhance its other digital products and maybe even turn a profit from this very popular application. Wall Street was hardly enthusiastic. In fact, the only thing that gave MSFT a boost was news that David Einhorn, a highly successful hedge fund manager, took time away from negotiations to acquire a 25% interest in the beleaguered New York Mets baseball team to note that his funds had bought a hunk of MSFT. He thinks the company is a wonderful, undervalued asset that would benefit if Steve Ballmer, who succeeded Bill Gates as CEO, moved on. MSFT lost 7%. **Maxim Integrated**, the analog and digital chip designer, fell 6.5%. For a tech stock MXIM pays a 3.2% dividend, while MSFT pays 2.7%. In fact, with the exception of **Symantec**, all of our tech positions pay something ranging from **Xerox's** 1.7% to **Columbia Seigman Premium Tech Fund's** 9.8%. The outsized yield on STK comes thanks to its strategy of using options to supplement its long positions. In a moderate market that strategy flourishes, and in a falling market provides some cushion. **SA**

Income With Growth	Symbol	Exchange/Phone	Price	Yield**	Buy Limit	Action
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.97	4.26%	\$17.00	BUY
CommonWealth REIT***	CWH	NYSE	\$25.35	7.89%	\$30.00	BUY
Telecom New Zealand	NZT	NYSE	\$9.53	6.74%	<b>\$10.00</b>	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$86.57	0.25%	\$100.00	BUY
CarMax	KMX	NYSE	\$27.94	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$29.21	2.12%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$24.23	1.87%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$36.98	1.34%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$113.18	1.14%	N/A	BUY
Fastenal	FAST	NASDAQ	\$31.36	2.26%	<b>\$35.00</b>	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$21.81	1.65%	N/A	BUY
Honeywell	HON	NYSE	\$57.25	2.33%	\$62.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$27.96	0.57%	\$32.00	BUY
Johnson & Johnson	JNJ	NYSE	\$66.09	3.45%	<b>\$71.00</b>	BUY
Leucadia National Corp.	LUK	NYSE	\$33.88	0.74%	\$38.00	BUY
Mattel	MAT	NASDAQ	\$25.69	3.58%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$23.91	2.68%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$44.19	2.17%	\$54.00	BUY
Paychex	PAYX	NASDAQ	\$30.54	4.06%	\$40.00	BUY
Pfizer	PFE	NYSE	\$20.84	3.84%	\$23.00	BUY
Stryker Corp.	SYK	NYSE	\$60.20	1.20%	\$70.00	BUY
Superior Industries	SUP	NYSE	\$20.57	3.11%	\$27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$22.60	0.00%	\$30.00	BUY
Third Avenue Value Fund***	TVFVX	800-443-1021	\$52.03	1.86%	N/A	BUY
Time Warner	TWX	NYSE	\$35.17	2.67%	\$40.00	BUY
United Parcel	UPS	NYSE	\$71.15	2.92%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$48.85	4.26%	<b>\$53.00</b>	BUY
Wal-Mart Stores	WMT	NYSE	\$53.66	2.72%	\$60.00	BUY
Xerox	XRX	NYSE	\$10.00	1.72%	\$14.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$24.08	0.00%	\$30.00	BUY
EnCana	ECA	NYSE/TSE	\$33.26	2.41%	\$37.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$34.64	0.16%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$39.70	4.23%	\$48.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$19.01	0.54%	\$21.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$39.47	11.67%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$8.47	0.00%	<b>\$9.00</b>	BUY
Boston Scientific	BSX	NYSE	\$6.87	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$27.43	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$12.40	7.02%	\$12.67	BUY
Maxim Integrated	MXIM	NASDAQ	\$25.87	3.25%	\$29.00	BUY
PowerShares Senior Loan Portfolio ETF	BKLN	NYSE	\$25.06	3.64%	\$27.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$18.90	9.80%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$18.51	0.00%	\$20.00	BUY
<b>Tellabs</b>	<b>TLAB</b>	<b>NASDAQ</b>	<b>\$4.33</b>	<b>1.85%</b>	<b>\$5.50</b>	<b>BUY</b>
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$11.66	7.16%	N/A	BUY
Transocean	RIG	NYSE	\$66.78	0.00%	\$90.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$33.10	0.00%	N/A	BUY

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

\* Prices as of Friday, June 3, 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 that benefit from a recovering economy.

### The Key Indicator

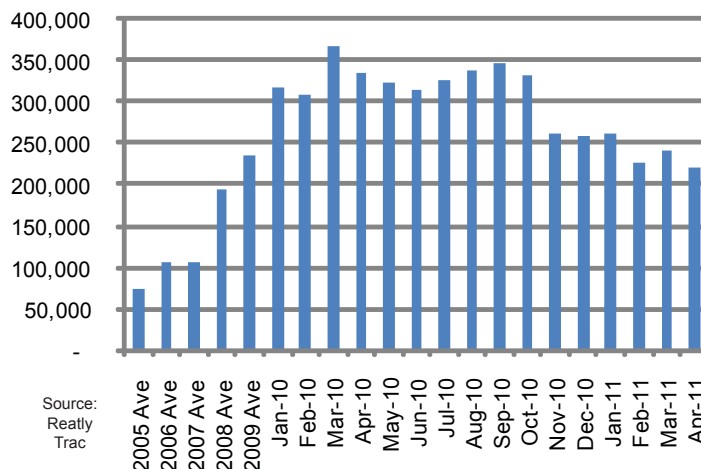
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive data base. You can access foreclosure information on local markets from their website [www.realtytrac.com](http://www.realtytrac.com). We use some of their data here to gauge the state of the nation and its 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 the time January 2010 rolled around, 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. However, industry experts explained that the decline was temporary and due primarily to a freeze by the Bank of America on 102,000 foreclosure actions. JP Morgan Chase

### US Foreclosure Rates - Monthly Averages



also had a freeze on 56,000 actions. The GMAC unit of Ally Financial also had a freeze.

Then, beginning in the first quarter, a bumpy decline in foreclosure rates has been attributed to the bungled paperwork fiasco and lost documents that have severely restricted the ability to process foreclosures. RealtyTrac recently reported that "This slowdown [in foreclosures] continues to be largely the result of massive delays in processing foreclosures rather than the result of a housing recovery that is lifting people out of foreclosure...Nationwide, foreclosures completed in the first quarter of 2011 took an average of 400 days from the initial default notice, up from 340 days in the first quarter of 2010 and more than double the average 151 days it took to foreclose in the first quarter of 2007. The foreclosure process took much longer in some states...more than 900 days in New Jersey and New York... 619 days in Florida...and 330 days in California...more than double the average of 134 days it took in the first quarter of 2007."

### Dissecting the Foreclosure Process

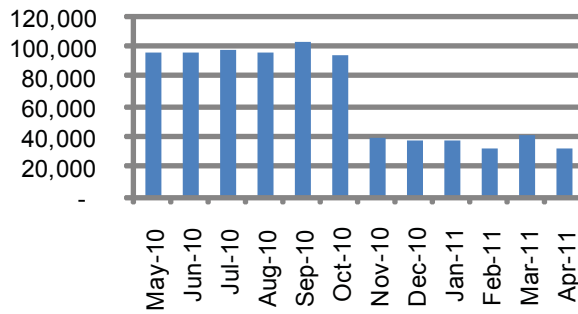
It's important to keep in mind that the foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures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

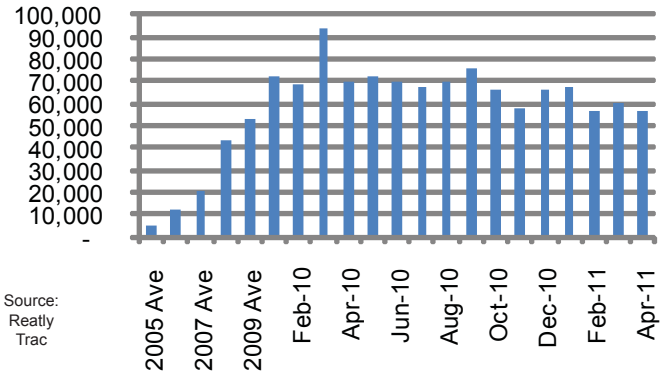
The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month. However in November they dropped to around 40,000 and have been bouncing around in the 32,000 to 40,000 range.

Initially the drop in new default notices during the fourth quarter was explained by the foreclosure freeze during that

US New Default Notices



California Foreclosures - Monthly Averages



Source: Realty Trac

quarter. However that freeze ended with the fourth quarter. The fact that new default notices have since remained substantially below peak levels is significant.

**Where are the Foreclosures?**

While the foreclosure crisis is a nationwide problem, the bulk of foreclosed properties are not evenly scattered across the country. The table below shows where two-thirds of the nation's foreclosed properties were in April.

Foreclosure Activity - April 2011

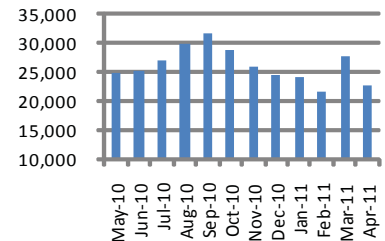
	Number of Properties	Percent of Total	One in every	Monthly Change
US	219,258	100.0%	593	-8.6%
CA	55,869	25.5%	240	-7.3%
FL	19,649	9.0%	451	-0.3%
AZ	13,419	6.1%	205	-14.6%
MI	12,996	5.9%	349	-11.1%
NV	11,761	5.4%	97	-8.8%
IL	10,055	4.6%	526	-16.6%
TX	8,793	4.0%	1106	-20.2%
GA	8,479	3.9%	479	-35.0%
OH	7,692	3.5%	640	-15.6%

Nevada (NV) has earned a reputation as the foreclosure capital because it has the highest number of foreclosures in relation to the number of houses there. The table shows that 1 of every 97 houses was foreclosed upon in April, which is the highest concentration of foreclosures in the nation. 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 account for over two-thirds of the nation's foreclosures. Any changes in these two states should lead to a significant change in the trend for the national economy as a whole. Take a look at the chart of California Foreclosures - Monthly Averages.

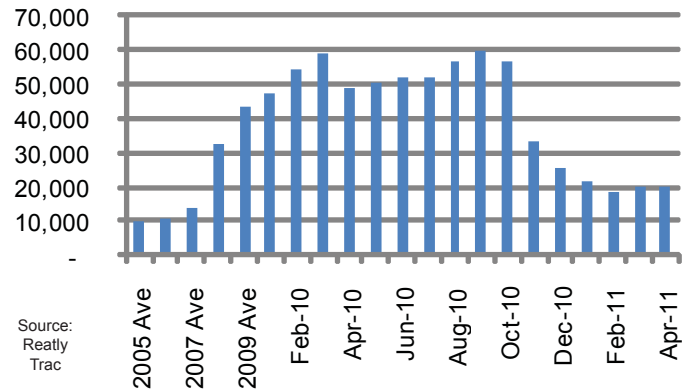
In 2005, California foreclosures averaged 5,138 properties. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Although foreclosure rates have declined somewhat, they are still historically high with no convincing downtrend. The same can be said for new default notices in California, which are shown on the next chart.

Now take a look at the Florida charts. Foreclosure rates there have fallen off significantly since the fourth quarter, and so have new default filings. Unless we see spikes in

California New Default Filings

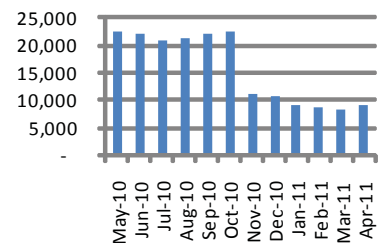


Florida Foreclosures - Monthly Averages



Source: Realty Trac

Florida New Default Filings



new default filings there, it appears that the worst is over in Florida.

**Conclusions**

In view of the fact that new default notices are staging a significant decline nationally and in Florida, we believe we are witnessing the beginning of the end of the entire crisis. However, we must still keep a close eye on the aggregate number of foreclosures because it represents the mass of the problem that must ultimately be worked out to free the economy of this burden. 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. That will mean you can make enormous profits in real estate, as well as other investments that benefit from a robust economic recovery. 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 \$7,649,824 in stocks and to \$1,158,511 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 \$304,049,065, 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 1.51. 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 75 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. This reveals a strengthening economy and 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 23.0 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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