



## Plowing Through the Blizzard



Since our Diffusion Indexes flashed a Caution Signal on April 13, the downdraft in the market has wiped out most of this year's gains in the S&P500, leaving it only 1.6% above its January 1st opening. The *Sound Advice* portfolio is still up 5%. Thirteen of the 24 *Sound Advice* model portfolio positions are up, 2 are unchanged, and 9 are down. We have an average gain of 24.4% based on the prices at which each stock or mutual fund was recommended.

Although we are in a cautionary mode due to the most recent signal from our Diffusion Index of Lagging Indicators (see page 9), we view this recent correction as a buying opportunity. Granted we are in the midst of the blizzard of bad economic news.

In our January Issue, we discussed the fundamental problems in Europe, and warned that conditions were going to deteriorate. We sold several positions, eliminating those that had heavy exposure to Europe. As these problems have begun to materialize, dampen the US economy, and dominate the headlines, it is easy to become bearish.

However, we must keep in mind that economic weakness leads to low interest rates -- the primary fuel for a major uptrend in the stock market. Take a look at the 10-year Treasury bond. The yield is close to 1.5%. We have never seen this yield so low.

We don't need another quantitative easing -- it is already here.

*-Gray Emerson Cardiff*

For the reasons discussed in the sidebar to the left, we view the recent correction as a buying opportunity. It is easy to get swept up in the midst of a blizzard of bad economic news. However, keep in mind that this is a correction -- and only that.

The guiding light is the fact that interest rates are historically low, as exemplified by the incredibly low yield on 10-year Treasury bonds. Low interest rates mean that the primary trend is up. It is as simple as that.

Here is a progress report on our current recommendations. We begin with our stock recommendations (in alphabetical order), and then the mutual funds. See the table on page 10 for specific recommendations and upper price limits for buying.

**AMN Healthcare (AHS)** is still up 27% for the year. As the nation's innovator in healthcare workforce solutions, including managed services programs, recruitment process outsourcing solutions, recruitment and placement of healthcare professionals into temporary and permanent positions, AHS will be sensitive to the general economic conditions. AHS has attractive valuation with strong growth fundamentals.

**Agrium (AGU)** pulled back in May, closing at \$75.54 per share on Friday, on concerns that Europe's worsening debt crisis and slowing Chinese economy will curb demand for fertilizers, as well as disappointing first quarter earnings that were down 1.8%. However, hedging losses on natural gas prices masked stronger earnings from operations which were actually up by 21% from a 23% increase on sales from higher volumes across its product lines. Its retail sales jumped 35% on strong demand for crop products and services in North America.

Although concerns prevail regarding a slowing global economy, global demand for crop nutrients continues to increase. In North America, Australia and Western Europe, but especially here, the scientific use of fertilizer is commonplace. Elsewhere farming techniques often resemble what we used to do 40 years ago, or worse. Compare the situation in the US to that of China. The US accounts for 5% of the world's population but has 13% of its arable land. China, which holds 21% of the world's people has only 9% of arable land. If emerging markets are to meet their populations' need for food, they will either have to import foodstuffs from the more advanced countries or, better for the fertilizer industry, use fertilizer to improve their crop yields. Either way means more use of fertilizers. This recent decline has reduced our profit to 526%. AGU is still up 12.6% this year. We consider this dip a buying opportunity.

**Associated Estates Realty Corp (AEC)** owns apartment properties, one of the most successful REIT sectors over the last two years as demand for apartments has surged thanks to the abrupt fall in home ownership, which in turn has been fueled by two factors: first, millions of homeowners find themselves unable to make their mortgage payments or find them too onerous given the drastic drop in home values and second, the whole idea of owning a home has lost its luster. Rents are rising and residential real estate investment trusts have outpaced other REIT sectors. This is a good value because the price of this apartment REIT is substantially below the equity value of its portfolio,

**The True Value:** Many analysts rely on the "book" value of a company's real estate as a number that represents the value of the company's real estate. But

the book value can be deceiving because it merely reflects what the company paid for its real estate. That could have been many years ago. The book value is also reduced by depreciation, an arbitrary number that has nothing to do with actual value.

To find the true value of a stock like this, we pull out the book value from the balance sheet, and substitute the market value of the real estate. The market value of commercial real estate is based on the net operating rental income it produces (after deducting operating expenses but before deducting any debt service payments). The net operating income from the real estate portfolio is shown on the company's income statement.

The most common and accepted method of valuing real estate is simply by the yield of the net operating income from the real estate portfolio. In real estate parlance, this is called the "capitalization rate". The math is similar to determining a bond yield: the higher the yield, the lower the price of the bond, and vice versa.

We have analyzed the other 9 major apartment REITs to see what capitalization rate the stock market is putting on the underlying portfolio. Capitalization rates vary substantially among these other REITs, but the average is 6.0%.

If we value AEC's portfolio by using the average cap rate (6.0%) of other apartment REITs, it translates into a stock value of \$29 per share – nearly double the current stock price.

Why does AEC trade at a cap rate that is out of line with its peers? In part, it has to do with the REIT's modest market cap, which discourages institutional investors from holding large positions. It might reflect concern that AEC has 48% of units in Midwestern buildings primarily in Ohio and Michigan, where unemployment is running high. These are older buildings with an average age of 18 years. Lastly, the market might remember where AEC began, owning subsidized apartments, and is not crediting the REIT for how it has changed.

Things have changed. AEC's portfolio has shrunk to 50 properties in seven states with 12,976 units, fewer than half of its inventory when its reform began. Between 2005 and 2009, AEC disposed of 31 properties with almost 7000 units, which mostly had been built in the 1970s, including all the subsidized units. Most of the sales were made during real estate's more buoyant years, whereas most of the new units were purchased during the current commercial real estate downturn.

The current inventory's quality shows marked improvement. Over the same period, AEC acquired six properties with 2,131 units that on average are six years old. Associated got these at below their cost of replacement. All are Class A and garner above-market rents. All have significantly higher operating margins than those that were sold off.

AEC recently repaid seven property mortgage loans totaling \$123.5 million, leaving no remaining debt maturities in 2012. Now, 38 of the company's 53 properties have no mortgage debt which were responsible for generating approximately 62 percent of first quarter 2012 net operating income.

Occupancies increased in the first quarter to 97.3% from 95.9% on the apartment properties owned during the quarter (same communities). Occupancies averaged 95.1% on properties acquired during the quarter. Revenues increased by 5.9% during the first quarter on the same communities. We look to more profits from AEC in the coming year.

**Boston Scientific (BSX)** reported higher first quarter earnings. One of its key markets for heart devices seems to be stabilizing. Its Epic Vascular Self-Expanding Stent System was recently approved by the FDA and launched to market. The Epic Stent is designed to open blocked arteries in patients with iliac artery stenosis (a form of peripheral vascular disease associated with severe leg pain caused by insufficient blood flow).

The FDA has recently approved several new pacemakers with proprietary features which will help BSX increase market share. The recent acquisition of Cameron will enhance its cardiac rhythm management business. The introduction of new products and global expansion will help them rise BSX off the bottom of its trading range.

The new CEO, Mike Mahoney, is from Johnson and Johnson, and has committed to following through with the current austere strategic plan, and promises to lead the charge in the current battle against Johnson and Johnson. This plan is already bearing fruit on Wall Street, and we expect to see more. BSX is the classic turnaround story.

**Chesapeake Energy (CHK)** moved up initially after our recommendation and then suffered a jolt when the company filed its quarterly 10-Q report and a Wall Street Journal article reported that CHK has more liabilities than previously estimated by investors and analysts. The stock went to new low territory, dropping to a low-point of \$13.32 a share on May 17.

The Journal estimated CHK's liabilities are higher by ap-

Gray Cardiff's Sound Advice is published monthly by S.A. Newsletters, LLC. Editor-in-Chief: Gray Emerson Cardiff. Managing Editor: Linda Cardiff. Real Estate Consulting Editor: John Mason. Subscription rate: \$195 per year. Send subscription requests to: Sound Advice, 939 Hartz Way, Suite 210, Danville, CA 94526. Phone: (925) 838-6710. Fax: (925) 838-0522. Information presented in Sound Advice may be used provided the newsletter—its name, address, and website—is mentioned as the source. The information contained herein has been carefully compiled from sources believed to be reliable, but accuracy cannot be guaranteed. ©2012 S.A. Newsletters, LLC. When securities are initially recommended herein, the editors, affiliates, and associates of the editors do not have positions in such securities and are required to wait at least seven days from the date Sound Advice is mailed before placing orders for them. After the initial recommendation, editors and staff members may own stock of any or all of the companies discussed herein.

proximately \$600 million than previously thought due to its volumetric production payments (VPPs) owed to banks in 2012 and 2013. VPPs are deals made with banks to deliver specific amounts of oil and natural gas (rather than cash) each month in exchange for upfront cash. Moody's lowered its rating on the \$12 billion in long term debt because VPPs and other deals have raised total liabilities to \$23.6 billion. In addition, Morningstar reduced its fair value estimate of the stock from \$32 to \$27 per share.

While not good news, when put into context of the overall \$23.6 billion in liabilities, the \$600 million increase is not a game-changer. It is widely known that historically low natural gas prices have put CHK into a crunch, and it is raising cash through asset sales in order to raise cash and lower its long term debt. These concerns are why the stock is trading at such a low price.

CHK recovered from its low point as rumors circulated that Carl Icahn recently bought a 7.6 percent stake, making him the third largest shareholder. The rumors were verified. Icahn actually started buying on April 19 at higher stock prices. In keeping with his reputation of an activist investor in turning around companies, Icahn said he will demand the replacement of four board members at the June 8<sup>th</sup> annual stockholders' meeting – two for himself and two for Southeastern (the largest single investor) who already had Lou Simpson put on the board about a year ago.

To avoid turmoil at the annual meeting, CHK is bowing to Icahn's demands. Four board members just resigned to make the room. We understand there is a short list for candidates to replace Aubrey McClendon as chairman of the Board, although as the founder of CHK, McClendon will remain as a director and CEO.

Although Icahn and his constituents will not have a majority, the added attention is positive because the spotlight is on the board to do whatever it can to maximize shareholder value..

Separately, of note is the recent purchase of 3 million shares by BlackRock Inc. (NYSE:BLK), a savvy investment group. This purchase quintupled its stake in CHK.

We also note that futures prices for natural gas have been moving up during the last several weeks which are indicative that the historically low prices of natural gas under \$2.00 per million BTUs are just that – history. Our buy recommendation still stands because the reasons for our recommendation have not changed, which are discussed in the May Issue.

**CommonWealth REIT (CWH)** owns 518 properties leased to approximately 2,000 tenants. Properties are located in central business districts (CBDs) and suburban areas with concentrations in six metro areas: Philadelphia, PA; Oahu, HI; Metro Chicago, IL; Metro Denver, CO; Australia and Metro Washington, DC.

**The True Value:** Most real estate appraisers agree that real estate capitalization rates currently range from 6 to 9 percent depending on the type and location of the real estate. To be

conservative, we could use 9 percent, the high end of this range, to put a market value on the real estate portfolio.

Plugging the market value of the real estate into this REIT's balance sheet reveals that the stock is worth \$52 per share, more than double the current depressed price of the stock. Of course, when we see a value like this, our question is "what are we missing?" So we start looking for fundamental problems.

**Occupancy:** Of the 72 million square feet owned continuously by CWH since March 1, 2011, the "same store" occupancy was 84.8%. Same store occupancy was 84.6% at the end of the fourth quarter 2011, compared to 85.7% at the end of 2010. So, there has not been a significant change in occupancy.

**Lease Expirations:** A concern could be that a substantial amount of leases are about to expire, resulting in an immediate and substantial reduction of rental income. However CWH does not have exposure to a substantial amount of their leases expiring in any one year. Looking beyond 2012, there are no years with a substantial amount of expirations: 4.7 percent of all leases expire in 2013, 4.0 percent in 2014, and 4.0 percent in 2015. From 2016 through 2020, annual expirations range from 1.8 percent to 5.4 percent. No single tenant is responsible for more than 2.0 percent of total rented square feet.

**Dividend Coverage:** Another problem could be that the funds from operations (FFO) are not sufficient to cover the dividend, causing the market to question whether the dividend is sustainable. This is a valid concern because this REIT has a history of paying out more than it earned for a while, and then cutting the dividend. However, funds from operations available for common stock in 2011 were \$3.39 per share -- 169 percent more than the \$2.00 per share annual dividend. In the first quarter of 2012, FFO was \$0.88 per share, which annualizes to \$3.52, for plenty of dividend coverage -- 176 percent.

**Related-Party Management:** REITs typically have a staff of employees manage their properties. However, unlike most REITs, CWH has no employees. Its properties are managed by an outside company, REIT Management and Research (RMR). CWH and RMR have officers and relatives of officers in common, which make the payment of management fees a "related person transaction."

RMR is paid by an agreement that is peculiar in the real estate industry. In addition to being paid a property management fee based on a percentage of rental income (3%), RMR is also paid a business management fee based on the value of the properties. This unusual management structure can produce conflicts of interest and potentially excessive fees. Although we would like to see an arms-length management arrangement and lower management fees, the amount of the fees is factored in to the calculations of value and FFO.

**Anti-Takeover Provisions:** Another problem is the fact that the bylaws of this REIT prohibit any outside shareholder

from owning more than 9.8% of outstanding shares. In the event a person or group of persons acquires 10% or more of the outstanding common shares, management is entitled to purchase additional shares or other securities or property at a discount.

Without this provision, this REIT would be an obvious takeover candidate because the real estate could be acquired for close to 50 cents on the dollar through the purchase of the REIT's stock. Absent this provision, this REIT's stock would not be trading at such a discount because suitors would certainly be bidding up the stock in takeover attempts.

**Trends, Discounts, and Premiums:** It is no secret that rental rates on office properties have been declining in recent years. Wall Street spends most of its time over-reacting, and hates negative trends just about as much as it loves positive ones. It will put a steep discount on companies with negative growth and a premium on those with growth prospects.

In the fourth quarter, CWH's same store net operating income (NOI) was lower by 10.9% compared to the prior year's fourth quarter. As a result of declining rental income, "normalized" funds from operations (FFO) were down by 13.7% in 2011 to \$3.39 per share in comparison to \$3.93 per share in 2010. Normalized FFO is useful information because it can be compared to prior periods. (Normalized FFO differs from FFO because non-operational and extraordinary losses and gains are excluded, such as those related to acquisition costs or property sales.) Of course, it is only natural to project this negative trend into the future, and discount the stock heavily until the downtrend is visibly reversed. However, a deeper look reveals that this downtrend is reversing.

**The Shift to CBDs:** Since the beginning of 2008, management has been repositioning the portfolio from suburban properties into high value central business district (CBD) office properties. CWH has since acquired \$3.3 billion of CBD office buildings which now represent 45% of the portfolio.

The benefit of repositioning into CBD office properties from suburban markets is becoming evident. The Company's weakness in funds from operations in 2011 was attributable to the suburban properties. Leasing activity (new leases and renewals) in the suburban office portfolio resulted in a decline in rents. By contrast, leasing activity in the CBD office portfolio resulted in an increase in rents, and occupancy in the CBD office portfolio increased.

In the first quarter 2012, there was further evidence of the benefit of moving into CBD properties. Normalized FFO was \$0.91 per share, which was 19% higher than the fourth previous quarter. The first quarter annualizes to \$3.63 per share – 7.4% higher than in 2011.

**Conclusions:** The down trend in office rents is scary and is a large factor in the discount of the stock price. The lack of arms-length transactions with management and excessive fees is distasteful, and so are the anti-take-over provisions. However, these are the reasons we can buy into a large real estate portfolio at less than 50 cents on the dollar.

We are starting to see the benefits of the shift to CBD properties. When Wall Street sees first signs of sustainable growth, the discount is certain to shrink which will bring us a capital gain. Meanwhile, we can collect a secure 10% dividend -- a yield that is off the charts these days in comparison to other investments.

**Comcast (CMCSA)** increased its total customers by 565,000 to 50.4 million during the first quarter. Meanwhile video customers declined by 37,000 to 22.9 million although the average revenue increased 7.8% per video subscriber.

There is buzz that Apple TV is working on a new Apple-branded HD TV. Because Apple TV boxes connect to the internet, and Comcast markets internet connections, CEO Brian Roberts indicated he would happily encourage Apple because the new box would increase internet customers.

Comcast's acquisition of NBC Universal has given it an edge over its competition by controlling more content, especially video streaming. CMCSA is looking to use their content libraries as a way of boosting revenue. Although, as a result of a couple of bombs at the box office, "Battleship" and "The Five Year Engagement", NBC Universal, is likely to have a negative second quarter. The housing recession has had a dampening effect on CMCSA as foreclosures and the accompanying financial stress has reduced customers. So CMCSA is an indirect play on the real estate recovery.

**Leucadia (LUK)** is a holding company with a portfolio in excess of \$9 billion of assets that is as focused as the wide-ranging eyes of its two principals, Ian Cumming and Joseph Steinberg, who have been compared to Warren Buffett in their success at identifying lucrative investments that can be purchased substantially below their intrinsic value. In fact, Buffet continued to team up with the Leucadia team on joint venture investments.

Skillful investing has produced double digit growth rates in its assets since 1979. After a bad year in 2008, assets have since grown by 150 percent according to Morningstar. We think that Leucadia is valued well below the market prices of its disparate parts. Owning shares in Leucadia is the best way we know of participating in the private equity market without paying outrageous fees to managers with mediocre performance. Instead, you get world class smarts at a very reasonable price.

**Masco (MAS)** manufactures a wide range of products for home construction and remodeling. Masco covers everything from kitchen cabinets and faucets to windows and paint. Its brands such as Delta, Milgard, and Behr are well known to anyone who spends time at the hardware store. Not surprisingly the shares got hammered during the downturn. Management has been through tough times before, and began cutting costs even before the housing sector went into free-fall.

We added MAS to the *Sound Advice* portfolio in October last year at \$7.49, when it was languishing in the doldrums. Masco offered several attractions. For example, the price to sales ratio had not been that low in over a decade. Although

losses had wiped out earnings, a significant portion of those losses represented the writing off of goodwill, which represented the price paid for acquisitions in excess of their tangible book value. However, we believed that the worst was over and the risk was out of the stock. The price nearly doubled after our recommendation. As it crossed \$11.50 a share, we changed our recommendation from a buy to a hold. It has since dropped back down to close to that price.

Masco is moving to consolidate debt, close unprofitable plants, formulate and implement new systems, streamline global supply chains and cut personnel to cut costs. They expect to save \$150 million of gross cost reduction before inflation with these policies

**Maxim Integrated Products (MXIM)** makes highly integrated analog and mixed-signal semiconductors. MXIM is a member of the Russell 3000, and it is one of the largest included in that index. It has recently won accolades for its solid state battery that harvests ambient energy. The device captures low-level energy forms, such as from photovoltaic cells, vibrations captured by a piezoelectric element, and heat captured by a thermoelectric generator. This device can eliminate the need to run expensive power cables to remote locations or reduce the frequency of battery replacements. The company is in excellent financial health with \$1.0 billion of cash and plenty of cash flow to support operations, as well as pay its quarterly dividend of \$0.22 per share. Even if MXIM's price ratios merely rise to the valuations of its average years, the share price should easily double from here.

**Paychex (PAYX)** core business is payroll services for small to medium sized companies. Accordingly, so its revenues and earnings directly mirror the employment situation. It is currently giving giant ADP a run for its money. The balance sheet is pristine with no long-term debt exposure. Based on the current price, the yield is close to 4%. This is a classic "buying straw hats in winter" opportunity that offers considerable potential for capital appreciation, along with safety, and a nice yield.

**Pfizer (PFE)** is cheap because the patent expired on its blockbuster drug, Lipitor. However, there are many new, potential blockbusters in the pipeline, especially Tofacitinib, its drug for rheumatoid arthritis up for review in early May, as well as Bapineuzumab, its high-risk but high reward drug for Alzheimer's. Also of interest is Eliquis for heart disease and blood thinning, and Bosutinib for Leukemia.

PFE has restructuring plans which include the spin-off of its animal health unit. In late April, PFE completed the sale of its nutrition unit to Nestle for \$11.8 billion. Much of these proceeds are to be spent on share by-backs which in itself should lead to a 5-6 cent increase in earnings per share. Pfizer is cheap at close to 10 times earnings and has nowhere to go but up.

**Retail Opportunities Investment Corp (ROIC)** began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. It started with

no debt and no problems. It is a simple model: buy distressed retail properties with high-quality demographics, refurbish them, and then lease them at a premium. Since inception, it has purchased \$654 million of shopping centers which ended the year with a 91.3% occupancy. Fund from operations (FFO) more than cover the dividend. As new properties are added, along with tenant upgrades, FFO should continue to rise, along with the dividend and price of this REIT.

**Stryker (SYK)** is best known for its orthopedic devices: artificial knees and hips, but it's much more. SYK provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, and neurotechnological and spine products. SYK recently announced the release of their System 7 – the next generation of surgical power tools. It has many other new products with over 100 patents in 2010 alone. It also has a reputation as having a good working environment, and it was ranked 68th on *Fortune Magazine's* "100 Best Companies to Work For" list from 2011. Future growth is guaranteed from aging the baby boomers as they need joint replacements.

**Symantec (SYMC)** is the dominant supplier of software for computer security and protection against viruses and other nuisances. As the world moves to smart phones and other mobile devices, hackers are starting to find security holes, and SYMC is the company to plug them.

SYMC has recently signed an agreement to acquire Nukona, Inc, a provider of mobile application management. This acquisition complements the acquisition earlier in March of Odyssey Software, a leading provider of mobile device management. The combination will enable SYMC to help customers secure mobile apps and data while managing and protecting from hackers by authenticating users and encrypting sensitive files. These acquisitions advance Symantec's leadership in the mobile device market by enhancing capabilities of the device, applications, and data protection.

**Tellabs (TLAB)** designs and manufactures hardware and solutions for the telecommunications industry, which in a world of exploding demand for wireless communications should be a bonanza of a business. Eleven of the Fortune 50 companies now rely on services provided through Tellabs' equipment. Don't forget that Tellabs' balance sheet holds \$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 current share price and you are buying the entire business for practically nothing.

**Tetra Tech (TTEK)** is a leading provider of consulting, engineering, program management, construction management, and technical services by providing innovative solutions to complex problems focused on water, environment, energy, infrastructure, and natural resources. TTEK is a leading company in water technologies. It designs complex and intricate plans that are used by local and national governments to meet future water needs, including desalination.

We like TTEK for its core businesses, and we also like

TTEK's healthy balance sheet. But most of all we think that water and environmental remediation are growth industries both here and internationally.

Because Tetra Tech designs and engineers water and other projects that are potential targets for terrorists, the company is incorporating security infrastructure into its work, and believes this could be a lucrative business. In addition, TTEK has gotten involved in Iraq, clearing explosives from battle fields, which is an extension of work it does for the military.

But we think the biggest potential business for TTEK lies outside the United States in countries like China and India, where environmental concerns have been at best an afterthought. Only now are their governments starting to recognize the consequences. As governments around the world make this a priority, Tetra Tech should be a prime beneficiary.

**Xerox (XRX)** has made huge progress in transforming the company from a seller of printers and copiers, which have thin profit margins and are highly dependent on economic conditions, to a company providing services on those machines. The revenue from services is more profitable and less cyclical. Now, half of XRX's revenues come from services. XRX expects to earn \$1.13 per share this year. At \$7.12, the price/earning ratio is 6.2 - a bargain.

## The Mutual Funds

**CGM Real Estate Fund (CGMRX)** is as good as they get for a REIT fund. CGMRX put on quite a fireworks show between 2003 and 2007 (+89.7%, +35.5%, +27%, +29%, +34.4%). We made a 145% profit during that period.

The fund's manager, Ken Heebner, who has run the fund since inception in 1995, is known as "The Mad Bomber" because he has never been considered cautious. He either outperforms or underperforms significantly, and this fund can be volatile, but Heebner's good years are really good. We watch his portfolio choices closely, so that we can judge whether the holdings make sense to us.

We got back into it again after the 2008-09 crash in REIT prices. Heebner has shaped his portfolio for maximum profits. His biggest bets are in residential (26% of his portfolio and retail at 21%). So far we have a large gain but there is more ahead. The good years of this fund are really good.

**Hambrecht & Quist Life Sciences Fund (HQL)** is a closed-end fund (CEF), which means it trades not at its Net Asset Value (NAV) but at whatever price the market sets, which can create a discount or a premium to NAV. HQL is currently trading at a discount to its NAV. We think HQL is a superior way to gain exposure to biotech, which admittedly is a volatile sector. However, the most explosive profits in the entire healthcare industry can be found here.

The Fund recently announced that it will be purchasing up to 12% of its own shares on the open market beginning in July. The share repurchase program is intended to increase

the Fund's net asset value per share and to reduce the discount the stock has from the net asset value. HQL is an attractive way to participate on a diversified basis, especially given the discount from NAV.

**Columbia Seligman Premium Technology Fund (STK)** is a closed-end fund, that enjoys an admirable pedigree but also has a conservative twist that provides some cushion from the tech sector's often rough ride.

Technology investing over the last two decades has been a feast or famine experience. Feast during the 1990s. Famine from 2000 to 2003 and again in the 2008-2009 meltdown. During the most recent recovery that dates back to March 2009, the Nasdaq, which is heavily populated by tech stocks, has led the other benchmarks.

This fund sells covered options against its portfolio which lowers volatility and produces cash income on the order of a 10 percent annualized yield.

**Third Avenue Focused Credit Fund (TFCVX)** sports a 7.5% yield. TFCVX specializes in distressed companies, from buying the still-performing loans of troubled companies to capital infusions, even to taking a company through bankruptcy; then emerging as equity owners.

The firm recently announced that it is making an equity investment in Millstein & Co. This is a firm started in 2011 by Jim Millstein who is known for his work with the U.S. Department of the Treasury as its chief restructuring officer, where he helped restructure the U.S. government's investment in American International Group (AIG).

TFCVX prides itself on its research and risk management, and in difficult markets it makes its portfolio more defensive by increasing its cash position. It recently sold off equity positions acquired when some of its holdings reorganized their debt, swapping equity for debt. But it was not passive when it came to deploying cash. It put \$190 million into existing positions that were selling at 68% of par, and selling off positions that had risen above its upper limit (108% of par). We do not have a profit here yet, but we think there are rich opportunities in distressed credits.

**USAA Precious Metals & Minerals Fund (USAGX)** is widely recognized as the best diversified way to invest in precious metals. Lipper, for example, rates it as the best performer in its sector over the past ten years, and it regularly has been included among the top-performing funds over shorter durations. *Morningstar* also puts it first among precious metals funds over the past three, five and ten year periods. And there's more, or should we say less: USAGX has accomplished this without taking on oversized risk. As *Morningstar* observes: "Over the past 10 years, the fund's standard deviation is only slightly higher than that of its peer group over the same period". So, this fund has posted the best returns in the category accompanied by slightly above-average volatility". *Morningstar* gauges that the fund has outdistanced other precious metals funds by 4.4% annually over the last decade.

Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$ 15.42	4.67%	\$ 18.25	BUY
CommonWealth REIT	CWH	NYSE	\$ 17.52	11.42%	\$ 22.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 12.04	3.32%	\$ 13.50	BUY
<b>Diversified Growth</b>						
CGM Realty Fund	CGMRX	800-343-5678	\$ 28.60	0.91%	\$ -	BUY
Comcast	CMCSA	NASDAQ	\$ 28.63	2.27%	\$ 32.00	BUY
Leucadia National Corp.	LUK	NYSE	\$ 19.99	1.25%	\$ 23.00	BUY
Masco	MAS	NYSE	\$ 12.04	2.49%	\$ 11.50	HOLD
Paychex	PAYX	NASDAQ	\$ 29.28	4.37%	\$ 33.00	BUY
Pfizer	PFE	NYSE	\$ 21.64	4.07%	\$ 23.00	BUY
Stryker Corp.	SYK	NYSE	\$ 50.01	1.70%	\$ 54.00	BUY
Xerox	XRX	NYSE	\$ 7.12	2.39%	\$ 8.00	BUY
<b>Energy/Natural Resources</b>						
Agrium	AGU	NYSE/TSE	\$ 75.54	0.60%	\$ 82.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 15.58	2.25%	\$ 18.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 27.77	0.20%	\$ -	BUY
Tetra Tech	TTEK	NASDAQ	\$ 24.32	0.00%	\$ 28.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 25.80	0.31%	\$ -	BUY
<b>Aggressive Growth</b>						
AMN Healthcare	AHS	NYSE	\$ 5.64	0.00%	\$ 6.50	BUY
Boston Scientific	BSX	NYSE	\$ 5.61	0.00%	\$ 6.50	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 13.66	7.91%	\$ 15.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$ 24.41	3.61%	\$ 27.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$ 16.44	11.25%	\$ 18.00	BUY
Symantec	SYMC	NASDAQ	\$ 14.37	0.00%	\$ 17.00	BUY
Tellabs	TLAB	NASDAQ	\$ 3.57	2.24%	\$ 4.50	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$ 9.85	7.70%	\$ -	BUY

ROWS IN **BOLD** INDICATE A CHANGE IN ACTION OR LIMIT

Prices are as of 6/1/2012. See our website for live pricing and buy limits.

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

Yields on funds do not include distributions of capital gains. Note that all fund distributions fluctuate annually.

Mark Johnson, who has managed the fund for the past 17 years, has shown a talent at making the right decisions during his tenure, and, since we consider funds managed by industry veterans superior to index funds, we cannot think of a better way to play gold and precious metals than this fund.

**Fidelity Select Natural Gas Fund (FSNGX).** The price of oil -- the world's benchmark for the cost of energy -- is north of \$100 per barrel again. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. (This value is approximate because various grades of oil have slightly different heating values.) So if a barrel of oil is say, \$100, that is the cost of 5.8 million BTUs of energy.

On the other hand, the market price for natural gas today is \$2.27 for one million BTUs. To buy 5.8 million BTUs will cost \$13.17 (5.8x\$2.27). So the same amount of energy is

available for approximately 13.17 cents on the dollar -- if it is in the form of natural gas.

The US is self-sufficient in natural gas with only 9 percent imported from Canada. At approximately 13 cents on the dollar versus oil, natural gas is bound to have a growing role in America's energy needs as well as independence from importing oil.

This fund is well positioned to benefit from an expanding natural gas industry. Yet defensive holdings in utilities along with companies with oil interests has provided diversification and balanced risk. Although natural gas prices have declined since the first of the year, this fund has not suffered -- evidence that the investment strategy of this fund is working.

## 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 \$7,517,882 in stocks and to \$1,253,723 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 \$298,804,945, 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 1.31. This reading reveals that stock values are below average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the 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. Since that signal, the market climbed 61 percent.

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 Diffusion Index of Lagging Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which reveals that the economy is about to put upward pressures on interest rates.

This index hit 100% in April, telling us to move to a cautious approach. Our next signal will come from a zero reading our Diffusion Index of Leading Indicators, which currently stands at 75 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 23.1 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 declined at an annual rate of 2.79 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	April-12	1,370.26

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

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

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

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

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

### The Key Indicator

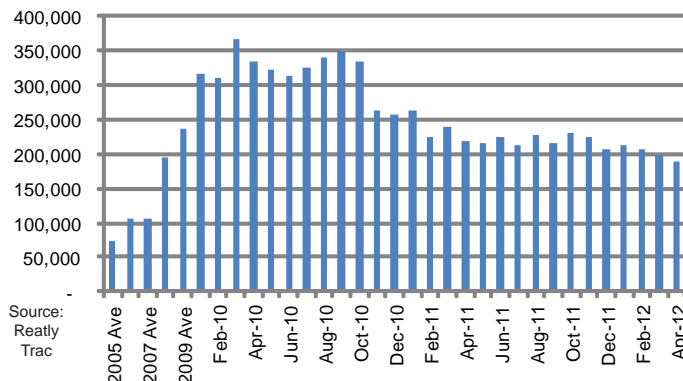
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive database. You can access foreclosure information on local markets from their website [www.realtytrac.com](http://www.realtytrac.com). We use some of their data here to gauge the state of the nation and its 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 January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the 2010 fourth quarter. At first, the decline was due largely to a freeze in foreclosures by several major lenders. The downtrend continued as Federal and state foreclosure prevention efforts allowed distressed homeowners to stave off foreclosures.

### US Foreclosure Rates - Monthly Averages



However, foreclosure rates remained stubbornly high with only slight declines in February, March, and April.

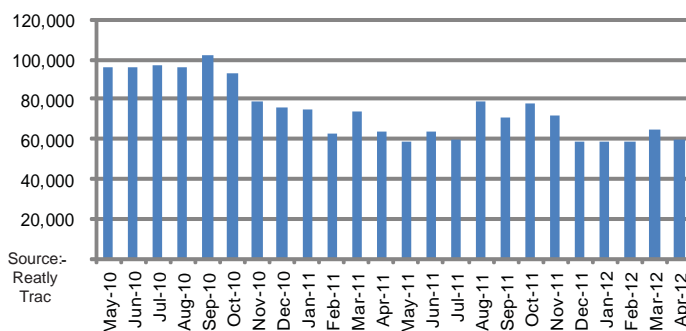
### Dissecting the Foreclosure Process

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 2010 they began declining but have remained stubbornly high, with an increase of 10% in March and a 7% decline in April.

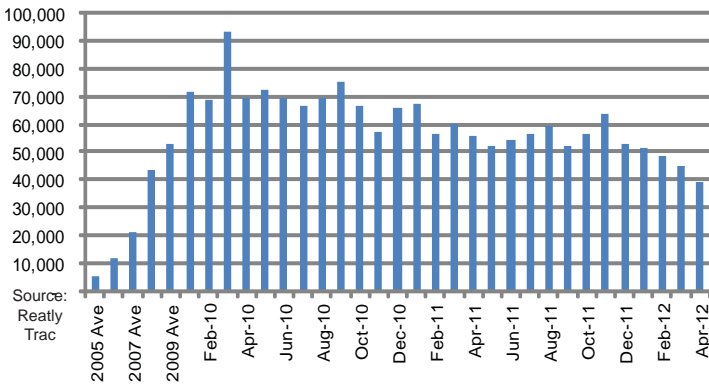
### US New Default Notices



One fourth of the nation's foreclosures have been in California for the last few years. The following chart shows all stages of the foreclosure process in California (including auctions and bank repossessions).

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

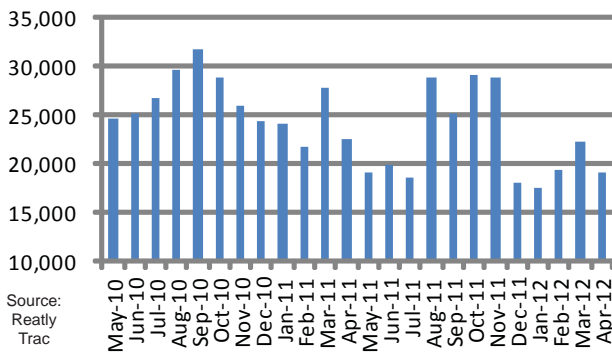
California Foreclosures - Monthly Averages



Foreclosure rates remained high in 2011 and began modest declines during the first quarter of 2012, and then a 13.2% decline in April.

Below is a chart of new default notices in California. In August 2011, new default notices in California jumped a whopping 55 percent to 28,961. After a decline in September by 13 percent, new default notices in California increased

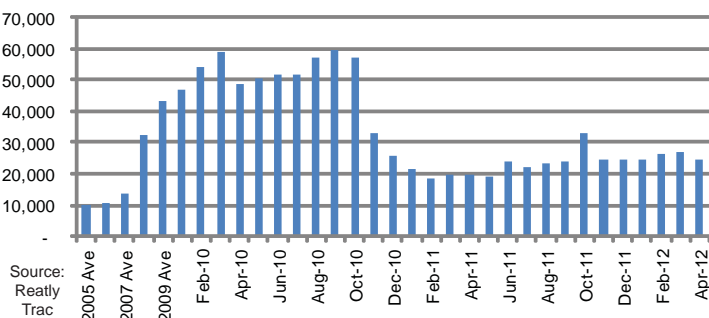
California New Default Filings



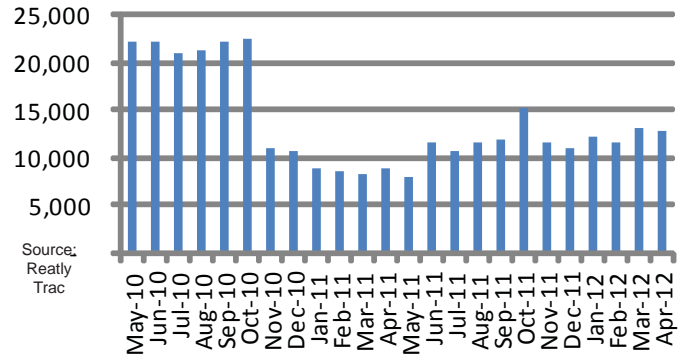
in October to 29,240 and in November to 28,897, but then dropped sharply in December and January. However, February saw a 12% increase followed by a 14% increase in March, and then a 14% decrease in April.

Florida is the next highest foreclosure state with 11 percent of the nation's foreclosures. See the chart below. Foreclosure rates climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the monthly rates

Florida Foreclosures - Monthly Averages



Florida New Default Filings

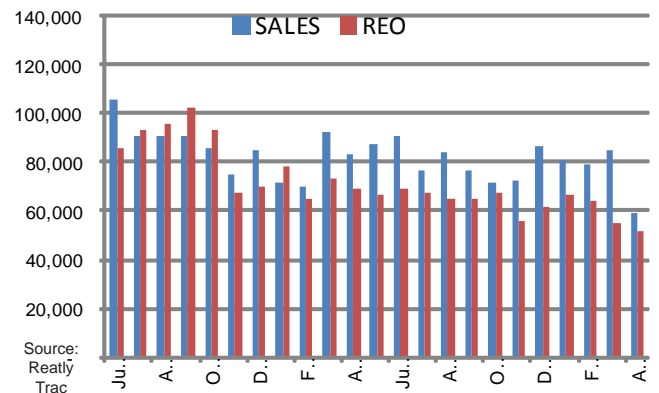


dropped sharply through May 2011. Foreclosure rates spiked in October 2011 and have been creeping up since.

New default notices have been increasing in Florida during the second half of 2011, and continued to increase in the first quarter of 2012. April saw a small decline of 1.9%.

The Inventory

At the other end of the foreclosure process is what the banks have not been able to sell. This inventory is called "real estate owned", or REO for short. Each month more REO is added to the inventory. However, each month there are a number of properties sold from the inventory. Below is a chart of the REO (in red) and sales (in blue) since June, 2010.



On balance, there have been 242,388 more properties sold than have been added to the REO inventory, or 18.3% of the current inventory of 1,322,944 foreclosure properties listed for sale.

Conclusions

Not much REO is selling. New default filings declined modestly nationally and Florida, Only in California which was there a significant drop. With these mixed results, there is no conclusive evidence that the crisis is getting any better.

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

SoundAdvice  
140 Town & Country Dr.  
Suite E  
Danville, CA 94526



First Class Presort  
US Postage  
PAID  
Permit #162  
Danville, CA

Address Service Requested

Enclosed: The June Issue of SoundAdvice

---

**Save 56% to 68% on your renewal to SoundAdvice**  
**Renew online: go to [www.soundadvice-newsletter.com](http://www.soundadvice-newsletter.com)**  
**or fax or mail in the renewal coupon below.**

SoundAdvice / 939 Hartz Way/ Suite 210 / Danville, CA 94526 Fax 925-838-0522, or call 800-866-0026

- BEST DEAL! 24 Month Renewal for only \$125 - A 68% savings! Plus, you will receive:**




The latest edition of *The Science of Making Money in Turbulent Markets*. A \$59.95 Value...**YOURS FREE**. This is the book that explains all of the SoundAdvice indicators, including the Diffusion Indexes and the famous Risk Indicator, and exactly how they work so that you can update them yourself.

*The Sound Advice Special Situations* A \$29.95 Value...**YOURS FREE**. Here is a complete update of each stock and mutual fund in the SoundAdvice model portfolio. This will give you a chance to review your investments alongside our recommendations, to make sure your money is working the hardest it can for your future.



- GREAT DEAL: 12 Month Renewal for only \$85 - a 56% savings! Plus, you will receive the latest edition of *The Science of Making Money in Turbulent Markets*. A \$59.95 Value...**YOURS FREE**.**

 **With either plan, you will receive: *Our #1 Investment of the Year*. A \$29.95 Value ... **YOURS FREE**. If you could make only one investment, this is it. Time is of the essence. You should invest right now.**

E-mail: \_\_\_\_\_ To receive your Printer-Friendly Issues and updates between Issues)

- Send me my Issues by regular mail. Add \$50 to cover printing and postage costs (\$25 for a 12-month renewal).

Phone ( \_\_\_\_\_ ) \_\_\_\_\_ - \_\_\_\_\_ (In case we have a question about the order)

- Enclosed please find my check payable to: SoundAdvice

- Please charge my Visa or MasterCard: Card #: \_\_\_\_\_

Expiration Date: \_\_\_\_\_ Security Code \_\_\_\_\_ (the 3-4 Digit Number on the back of your credit card)

- Yes! Add 3 months to my choice above. I Qualify for the Early Bird Special.**

(cut along dotted line)