

# SOUND ADVICE

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October 13, 2006

## To Fade, Or Not To Fade

We're now at the point that rather than contemplating \$4 a gallon gasoline or \$100 a barrel oil, we are reading articles asking when \$1.15 a gallon gasoline and \$30 a barrel oil will arrive. Perhaps these ultra-bearish expectations will come to pass, but most of the rationale for such a dramatic collapse in energy prices depends on the very reasons we think such prices are unlikely. The only way prices might approach these levels would involve a serious reversal in the U.S. economy along with a collapse in the economies of emerging markets, especially China and India. We're not saying such a reversal of circumstances is impossible. We are saying that it is unlikely.

Nonetheless, expectations that energy has had its day reflect the pervasive instinct for projecting into the future what is happening in the present. Certainly energy prices have weakened. Gas at the

pump here in Northern California is below \$2.50 a gallon, a dramatic decline from the \$3.39 we were paying just a few months ago. Oil is now in the low \$60s a barrel. Natural Gas has tumbled more than 60% since it hit highs in the wake of hurricanes Katrina and Rita. With this as recent memory, why not presume that happy days are here again for cheap energy?

Take an article by Charlie Blaine on the MSN/CNBC website that admitted \$1.15 a gallon gasoline is not around the corner but might be in "the next few years." Give me a break. When you hear someone try to talk seriously about markets and uses "The next few years" as the horizon, don't take him seriously.

Blaine notes that global tensions are easing, drivers are starting to change their habits, and more supply

is on the way. He might have also added that so far the hurricane season has not even struck a glancing blow on the Gulf of Mexico's infrastructure and that many anticipate a warm winter for the U.S.

Let's focus on supply and demand. Blaine supports his argument for drastically cheaper prices by anticipating new energy supplies, and points to the recent news about the Jack #2 well that Chevron, Devon Energy and Statoil are testing in the Gulf of Mexico, which conceivably could yield as much as the equivalent of 29 billion barrels of oil, which would add 50% to proven U.S. reserves.

However, we note that these potential reserves are six miles below the sea surface, and, should even the most optimistic expectations about how much is in this field prove true, it will be anything but cheap to develop and lift.

The simple fact is that the low-hanging fruit, fields that remain

economically accessible, are few, and that the costs for developing reserves located in more challenging environments do not point toward lower prices.

As for consumer habits, we start with the basic truth that Americans love their cars. Though we might all get religion about driving less, driving smaller, driving economically when gasoline prices spike, we fall back into our worst habits when gasoline prices drop. Should gasoline fall back to \$2, expect consumers to drive more, drive larger, and drive uneconomically. Also, should oil prices retreat more dramatically than they have, don't expect OPEC and other producers to just sit tight. Even now, OPEC members and other producers are talking about cutting production to support prices.

Global political instability is not going away.

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*Sound Advice* used to advise readers to be indifferent to transient political chaos when making investing decisions. In fact, we endorsed the Rothschild maxim that you should be a buyer when there is blood in the streets. Now, it seems, geopolitical instability is not a variable but a constant. The world seemed permanently set on tilt.

We have no friends in Venezuela, Nigeria is unstable, Iran appears to be the big winner from our adventure in Iraq, and the Mideast energy

suppliers are vulnerable to any number of destabilizing events that won't go away until Iran ceases to play nuclear brinkmanship, the flames in Iraq are quenched, and the challenge from jihadists bent on returning the Moslem world to the middle ages is defeated.

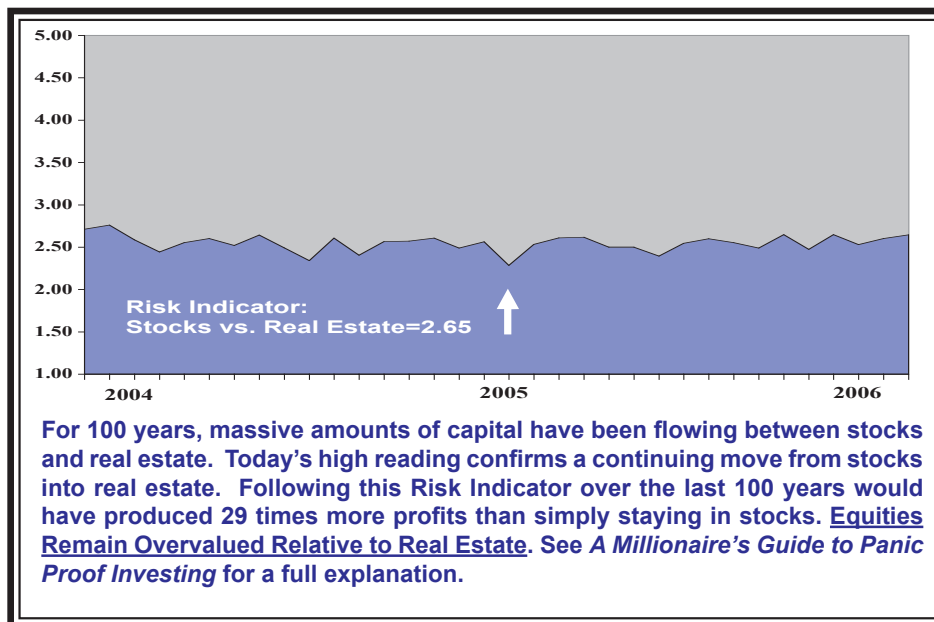
In short, we are willing to fade (gambler's jargon for accept the bet) the market's current disinterest in energy, and, for that matter, in natural resources and other hard assets, since nothing we read says anything positive about diminished demand for energy and other commodities, about the dollar's precarious situation, and about the inevitable consequences of America's and Americans' insatiable passion for debt to finance its governments and its households.

### **FLOWERS ARE NOT FOREVER**

Even if we have the future right, the simple fact is that our portfolio has taken hits in energy and natural resource investments. It doesn't make us happy but it is not devastating. As a glance at our portfolio shows, these still profitable positions account for less than 16% of what we own. The rest, a hodgepodge of value ideas, is doing fine.

Though some subscribers ask why we can't match the performance of sector funds which represent all-in bets on a single market theme, we prefer the diversification that comes from buying whatever individual situation catches our interest. Pure energy funds, for example, ran circles around our excellent returns over the last few years. That's OK with us. With energy weak now, the rest of the portfolio is carrying us.

For some, however, the decline in energy, especially the severe drop in natural gas prices, has been cata-



strophic. Consider Amaranth Advisors, a leveraged private fund that got on the wrong side of natural gas prices when it played the spread between successive months' price futures. Amaranth counted on the spread remaining wide between the March and April 2007 contracts. When that spread collapsed, Amaranth went down.

There is plenty of irony in its demise. Take, for instance, how Amaranth got its name. If you are a Greek scholar, you know that Amaranth was a mystical flower that supposedly never faded. Amaranth's founder and CEO, Nick Maounis, is no Greek scholar, but, according to the *Wall Street Journal*, after glancing at an antique pool table inscribed with the manufacturer's name, Amaranth, he decided it had just the right high-toned ring for his new fund. When someone explained the classical significance, he knew he had discovered the perfect name.

For the pool table manufacturer, the name "Amaranth" promised that the table's felt would never fade, definitely a virtue. Maounis thought he was slapping intimations of immortality on his venture. But any gambler would have recognized the irony, since as we noted above in gambling lingo to "fade" is to take the opposite side in a bet.

Indeed, it's the gambling context that sets the stage for the Greek tragedy Mounis set in motion with his attraction to "Amaranth," since what Mounis did with his and his limited partners' cash was to expose his fund to incredible risk by taking on, or fading, an enormous bet without a safety net.

In fact, Amaranth Advisors has been incorrectly called a hedge fund, which emphatically it was not, since hedging involves making a set of investments that diminish risk such as shorting a stock and buy-

*(continued on inside back cover...)*

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Now and again, *Sound Advice* runs an advertising campaign. Steve Horwitz, our Managing Editor, jokingly suggests we title the next one "You Won't Hear About the Next Google Here," which is his way of saying that we don't promise grand slams, because seeking once-in-a-lifetime returns almost guarantees losing what you've accumulated over that lifetime.

We see the same mailers as do you with claims so transparently impossible that you wonder why the sender wasted the paper and postage. Some of these mailers aren't really meant to entice subscribers, but are come-ons paid for by promoters seeking to pump and then dump shares they hold. But many others are trolling for people willing to plunk down hundreds of dollars to access sure-fire investment ideas, and resemble the Nigerian "oil minister's" scam email asking for your help to spirit funds out of his country in exchange for a 10% fee (10% of \$10 million whets the imagination).

We've been publishing *Sound Advice* for more than two decades. *Hulbert Financial Digest*, which tracks investment newsletters, continues to rate us highly for risk-adjusted performance over the past five years (#2 of 116 letters as of 10/06) with an annualized gain of 21.4% while the Wilshire 5000 returned 8.6%.

Horwitz more seriously suggests we pitch ourselves as recommending boring stuff that makes money. That wouldn't work either, but it might weed out gullible wackos hoping to recoup what they sent to that Nigerian "oil minister."

--Gray Emerson Cardiff

## A New Fingerprint for Index Funds

Index funds are the Everyman investment. Own them, forget about them, counsels the financial media, and you will do no worse (but no better) than whatever portion of the market each index defines. Even the shrewdest of stock pickers, Warren Buffett, recommends index funds for the average investor. *Sound Advice* over the years has criticized index funds in general and the Grand Daddy of them all, the Standard & Poor's 500 Index, in particular as stealth momentum investments. This month, we are recommending an entire family of index funds. We'll get to our recommendation in a moment, but first let's detour to current events to find the Achilles Heel of all traditional index funds.

### *IF THE DOW IS AT A NEW HIGH, WHY NOT THE S&P?*

There's been a good deal of hoopla lately surrounding the Dow Industrials' rise above its 2000 historical high. Bulls are bellowing that the market has finally emerged from the thicket of resistance levels created by the bear market, and now has an open field over which to charge higher. Bears swipe back that if you factor in inflation the Dow has not regained its zenith, and that the S&P 500, a more respected measure of the broader big-cap market, still remains 12% below its 2000 high. As for the Nasdaq, the ultimate bubble index, it is still so far away (-55%) from its euphoric apex that a return to that level seems unlikely for quite a while.

The challenge posed by the laggard S&P does undercut the Dow's attainment. Though we continue to be bearish for other reasons, there is an obvious answer to why the S&P has not confirmed the Dow: the Dow and the S&P measure different groups of stocks and measure them differently. First off, there is the obvious difference that the S&P covers 500 companies; the Dow 30. More importantly, the S&P 500 is a cap-weighted average, that is, the index reflects the market capitalization of its 500 constituent companies' shares. Though the Nasdaq Composite might be the ultimate bubble index, the S&P 500 also

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## Sound Advice on WisdomTree Dividend Top 100 Fund

owed its run-up during the bubble's build and climax to the same big tech/telecom names that drove the Nasdaq. It's reasonable to conclude that the S&P lags the Dow in part because its tech/telecom component fell so far. Indeed, at the start of 2000, six of the 10 biggest positions in the S&P 500 were tech/telecom names: Microsoft, Cisco, Intel, Lucent, IBM and America On Line.

Today, the S&P's largest component is Exxon-Mobil. Among the biggest 30 stocks in today's S&P a mere six are tech or telecom, and only one of those, Microsoft, makes it into the top ten. If you take one thing away from this article it is this: despite the common belief that S&P index funds, and for that matter, all traditional index funds, are the safest way to invest in equities, they have a serious defect. Over time, because they are weighted toward whatever is the dominant market sector, they always are loaded with overvalued shares and light on undervalued shares. Inherently, they benefit from but ultimately fall victim to momentum investing.

The Dow, on the other hand, is a price-weighted index. Price changes for GM and for AT&T have roughly the same impact on the DJIA, despite AT&T having five times GM's market cap, because each carries about the same weighting.

The Dow Industrials' run during the late 1990s' bull market was less fueled by momentum not only because of how it was weighted but also because its constituents

remained rooted in non-tech/telecom names. Admittedly, those responsible for governing the Dow Industrial Average were busy introducing tech and telecom as fast as they could, but even after Intel, Microsoft and SBC were added in 1999, Wall Street still considered the tech-poor DJIA stodgy compared to the Nasdaq and the S&P. If only because the S&P had more to make up than did the Dow, is it any wonder the Dow got back to where it was sooner than the S&P?

### ***INDEX FUNDS, A UNIVERSAL SOLUTION?***

Whether or not investors recognize the momentum flaw in cap-weighted index investing, index funds are the dominant investment vehicle. Certainly the average mutual fund—indeed 85% of all managed mutual funds—cannot match index funds' performance because fund managers are not smart or lucky enough to consistently beat their bogeys and, even if they could, the fat fees they charge reduce their performance below that of the indexes. Three trillion dollars currently sit in cap-weighted index funds, and despite the relatively modest fees they exact from investors, in aggregate they are tremendously profitable for fund companies. For instance, the Vanguard 500 Index Funds (there are two), which John Bogle midwived into existence, hold more than \$109 billion but charge a skinny 18 basis points a year.

The essential insight upon which index investing is based came from academic research that suggests it is impossible to predict how stocks will perform. Efficient Market Theory (EMT) argues that all information we can know about a stock is reflected in its current price, and that stocks move randomly, hence the so-called Random Walk Theory popularized by Burton Malkiel. If stocks move randomly, selecting individual stocks is just gambling. The solution is to own them all. We won't argue with this premise but how it is applied is open to alternative solutions.

Bogle, Malkiel and Buffett are right about the superiority of index funds for the average investor, not because the traditional index fund is an ideal investment but because when the average investor has to make decisions, in the long-run fear and greed will push him to buy when he should sell, and sell when he should buy. An index fund forces the investor to remain in the market, and since experience tells us that stock prices rise over time, he'll do fine. But Bogle in his zeal to evangelize every investor to abandon the sinful notion that they can outperform the market ignores some money managers who consistently outperform his indexes, and that most of them seem to be value-oriented.

How does Bogle account for the Marty Whitmans at Third Avenue or the team-created portfolios at Dodge & Cox? But Third Avenue and Dodge & Cox are managed funds

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## Sound Advice on WisdomTree Dividend Top 100 Fund

with selective portfolios. Investors who put their money with Third Avenue, Dodge & Cox, and other consistently successful managers rely on fallible humans to build their profits, and thus forfeit the index funds' universal ownership of every stock in a particular index.

For the last couple of years, arguments heard among academics about alternatives to the classic cap-weighted index fund have emerged into real-world investing. The common thread connecting them is a question: if the traditional cap-weighted index fund is essentially biased toward overvalued shares, is there some way to weight an indexed portfolio that removed this bias? Some have argued that using an equal-weighted portfolio would cure the problem, and certainly over the last six years as small and medium-cap stocks have surged while large-caps have lagged, an equal-weighted portfolio would have outperformed cap-weighted rivals. However, what seems to us a still better solution is now being put into practice by a fund here and a fund there: creating indexes weighted by one valuation measure or another.

### **WISDOMTREE**

This June, WisdomTree launched 20 Exchange Traded Funds (ETFs): six are domestic and 14 international. All of them are weighted not by market capitalization but by dividends. WisdomTree's insight is that high dividends not only are associated with underpriced stocks but also accelerate profits.

Why are dividends an indicator of value and a better way to weight an index? As you know, *Sound Advice* often cites a stock's yield among the various price ratios that indicate value, because

just as Price to Earnings, Price to Sales, Price to Book, or Price to Cash Flow ratios provide valuation references, a high dividend to price ratio (yield) also can indicate a company that has fallen out of favor or is just at the wrong place in the business cycle. If you are familiar with an investment strategy widely popular during the 1990s, The Dogs of the Dow, you appreciate how yield can indicate value.

What distinguishes this particular value indicator from other price ratios is that it is not just an indicator. It is literally money in the bank.

In our June 2005 issue in an essay, "Dividends, Who Needs 'Em?," we praised the then new

**These funds are an experiment worth participating in for value investors who appreciate the diversification of an index but have shied away because traditional funds ranked positions with a bias against value.**

book by Professor Jeremy Siegel, [The Future for Investors](#), which made the case for dividends as the key to investment success. When Michael Steinhardt, a very successful but now retired hedge fund manager, was approached to bankroll WisdomTree's family of index funds, he turned to Siegel to dissect the theory and to back test it using the historical data Siegel had sifted in his own research. Not surprisingly, Siegel endorsed the underlying theory, and after running extensive back tests, concluded WisdomTree's indexes outperformed their traditional index rivals.

In his book, Siegel confirms what my grandmother used to say: if you buy a stock, make sure it pays a nice dividend. Siegel takes this one step further: dividends when

reinvested are the primary driver for superior long-term profits. The impact reinvested dividends delivers is astonishing: "From 1871 through 2003," writes Siegel, "97 percent of the total after-inflation accumulation from stocks comes from reinvesting dividends. Only 3 percent comes from capital gains."

Put another way, reinvested dividends provide a compounding effect that amplifies stocks' price gains. In addition, during bear markets, a continuing stream of dividends reinvested methodically buys more shares at depressed prices; when prices are high fewer, pricey shares are accumulated. Not only does reinvestment force compounding, it also creates an automatic form of dollar-cost-averaging, two of the most powerful tools for passive patient investing.

WisdomTree funds stand on three premises: it is prudent to own an entire index, the good, the bad, the ugly. If you own a large universe of stocks, you should weight them using some value filter. Dividends as a value filter are not only predictive of underpricing but also reward the investment with cash, which when reinvested compounds over time.

Siegel did not simply bless the indexes WisdomTree proposed as a basis for their ETFs. He joined the firm as Senior Investment Management Advisor and sits on the board of directors. Last month, another advocate for individual investors, Arthur Levitt, an ex-Chairman of the SEC, respected for his work to make Wall Street a fairer arena for small investors, also joined WisdomTree as a Senior Advisor.

### **BUT WHICH FUND?**

All the domestic WisdomTree ETFs are significantly overweighted toward financial services stocks,

## Sound Advice on WisdomTree Dividend Top 100 Fund

though from fund to fund the degree as well as the nature of that exposure differs. In part this prominence reflects the general market's own bias: financial services companies account for anywhere from 22% (S&P 500) to 36% (Russell 1000). The WisdomTree Small Cap fund holds a staggering 58.9% in financials, while the Large Cap Dividend fund holds 30.2%.

If you probe beneath the sector category, you note that the Small Cap fund holds a disproportionate number of mortgage REITs while the Large Cap Dividend Fund financial sector exposure is instead to the largest financial conglomerates.

Siegel's back testing generated some impressive returns. Tracking each WisdomTree domestic index against its classic benchmark for the years 1980-2005, Siegel determined that annualized returns for the WisdomTree indexes would have been between 1.14% higher per year (Large Cap Dividend vs. the S&P 500) to 5.01% (Small Cap Dividend vs. Russell 2000). Over that only-if quarter century, the 1.14% differential worked out to a 29% greater profit. As for the 5.01% difference, that 25 years would have almost doubled the Russell 2000's performance. We should mention that Bogle has been vitriolic in his attacks on WisdomTree, and dismisses these back tests as deceptive "data mining."

With just a jot more than a single quarter in real market history, the WisdomTree ETFs must be considered experimental. Nonetheless, it's worth noting that from their launch on June 16<sup>th</sup>, each of the domestic ETFs (we've not looked at the international ETFs) is outperforming the traditional index against which it is benchmarked.

It will take to time to decide whether this initial success is a

result of the underlying strategy that highlighted financials as undervalued or just the good fortune of being overweighted in financials, currently a hot sector. Since the dividend reinvestment aspect of the funds is so decisive, and naturally is effective only over a long period, this initial success presents just a slight but promising start.

We like the method applied to all the ETFs. Still, we must choose one, and recommend the **WisdomTree Dividend Top 100 Fund (DTN—NYSE)** for several reasons. Most importantly, it is the only domestic WisdomTree fund to weight its positions not by the amount of the cash dividend but by the dividend yield.

Yield, to our way of thinking, is a far better value indicator than absolute cash distribution, since yield places the dividend in relation to the stock price. In a cash-dividend ranked index, a \$20 stock that pays a \$1 distribution would be more heavily weighted than a \$10 stock with a 75 cent dividend, despite yielding 5% versus the \$10 stock's 7.5%. We prefer owning more of the higher yielding stock, because its reinvested dividends accumulate shares more quickly. Furthermore, cash distributions usually are higher for larger cap companies, and by favoring these fatter distributions in the ranking, such an index gives the largest cap stocks an advantage. Over time, we suspect that larger cap companies underperform smaller companies.

DTN takes the top 100 stocks from the WisdomTree Large Cap Dividend Index, which is composed of the 300 largest cap (average market cap of \$24 billion) dividend paying companies in the WisdomTree Dividend Index. At present, the largest position (3.82%) is Southern Copper, which yields 8.63%. The rest of the top

10 are: Lincoln National Corp (1.87% of portfolio/2.38% yield), General Motors (1.86%/3.22%), AT&T (1.15%/4.19%), Consolidated Edison (1.5%/4.95%), Progress Energy (1.49%/5.42%), Reynolds American (1.49%/4.8%), Xcel Energy (1.45%/4.29%), Ameren Corp. (1.42%/4.84%), and Bank of America (1.4%/4.13%).

The lower yields for some larger positions reflect price changes since weightings were established this spring. For instance, GM shares are up about 25% over that period, thus reducing the yield.

There is at least one other issue: Southern Copper's outlier yield is set each quarter by management, and depends on cash flow. With copper commanding hefty prices, cash flow and thus the distribution and yield are also hefty, but by their nature will fluctuate, which is not typical for dividends. Furthermore, this high yield is not indicative of an undervalued stock but reflects a company much closer to its price apex than to a bottom. Jeremy Schwartz, WisdomTree's Senior Analyst, notes Southern's peculiar situation but does not consider it to have significant impact on the overall portfolio.

DTN along with its 19 sibling ETF are still in their infancy, and undoubtedly will receive fine tuning in real time. We think these funds are an experiment worth participating in for value investors who appreciate the diversification of an index but have shied away because traditional funds ranked positions with a bias against value. These funds charge a modest 38 basis points, which while not as cheap as the cheapest traditional index funds could more than make up for that gap with superior results. **SA**

## PORTFOLIO UPDATES

The Dow moved above its all-time high set in early 2000, while the other benchmarks also surged. Consensus optimism revolves about the belief the Federal Reserve won't be raising rates again. Indeed, Wall Street seems to expect a cut in rates. Falling energy prices also convince investors that inflationary pressures are in reverse. For the moment, investors are ignoring anything negative. There is remarkably slight interest in asking where our ultra-deep federal deficit and trade imbalances might lead. Amazingly, the nation is riveted on a seamy sex scandal in Washington, which might say something about our leadership, but has nothing to say about where they are leading us. For the month, the *Sound Advice* portfolio turned in a 2.5% total return, and trailed the Dow's 4%, the S&P's 3.9%, and the Nasdaq's 6.2%—not surprising given how natural resources performed. We're still nicely ahead of these measures for the year. **Getty Images**, the September recommendation, came out of the gate nicely, up 7%. The catalyst was a Wall Street analyst reaching the same conclusion we had about the degree of punishment GYI had absorbed during 2006. As we wrote in the last letter: "Getty Images might have disappointed Wall Street this year in not hitting its promised targets, but Getty is perfectly focused on images, the single element that bridges all media, and has a bright future that its current price does not capture." The past quarter's results will be aired on October 24th when Getty Images does its conference call, which leaves plenty of time

for speculation about the quality of those results. Should they be good, expect to see the shares get another bump. Should they be so-so, watch closely, since if GYI can hold above \$45, it would be very good news. In any case, we think Getty Images will do fine."

provided to laptop manufacturers. **Safeway** gave back 6.5% perhaps because it deepened its commitment to online grocery sales when it bought the rest of the company that maintains its online ordering and delivery service, though more likely is a spate of analyst

### Password for Online Updates and Next Issue

The **NEW PASSWORD** for Updates to be published at our website, [www.soundadvice-newsletter.com](http://www.soundadvice-newsletter.com), at the start of November will be **windy**. To access the November issue when posted online (Monday, November 13th) **the same password, windy, should be used.**

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Though Getty's start is gratifying, this is not to be expected each month. Sometimes we recommend a company and the following week it craters or soars when bad or good news is announced. Unlike Wall Street analysts, who live and die by the stopwatch, we prefer to work with sundials, and often it takes years for some recommendations to work out (or fail).

We say most of what needs to be said about energy, commodities, and precious metals in the cover story but want to add the perspective of Bianco Research, a respected bunch of number-crunchers, who point out that the latest drop in energy prices represents the seventh such retreat of 15% or more, each of which in the past was followed by a march to new highs. Of course, there is no guarantee that the past is a template for the future, but Bianco lets us substitute experience for anxiety. **Sony** had a poor month, down 11.2%, hurt by continuing recalls of potentially defective batteries it

comments that revive concerns about competing against **Wal-Mart** explains the loss. We think SWY can hold its own. **Wal-Mart** added 3.4%, we believe, as part of the overall rally rather than any surge of interest in WMT.

Our two food companies, **ConAgra** and **Sara Lee** had an even better month, as rumors are swirling that SLE could be acquired in a leveraged buy out. Last month, we vented our frustration at Sara Lee's inability to excite investors, and warned now that **Hanesbrands** had been spun off, that our patience was wearing thin. Who knows? Maybe Sara Lee got our message. SLE added 13.7%. CAG, up 6.3%, might be tagging along, since now that SLE is only a food maker, perhaps the logic that makes it a buy-out candidate is being applied to CAG too. **Molson Coors** did not get frothy, losing 5.7% as a couple of analysts worried about beer sales not just at TAP but industry wide. There's nothing new here, and TAP is worth accumulating.

## Sound Advice: Portfolio Updates for October 2006

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The drop in energy prices is not entirely painful, and has boosted some of our positions. **Agrium**, the fertilizer maker, consumes natural gas as the feedstock for its nitrogen-based products, and gets a margin boost with natural gas prices low. AGU added 17.5%. **Newell-Rubbermaid** makes its plastics using natural gas as a feedstock, and added 7.8%. Perhaps even **Mattel**'s strong performance is helped by cheaper plastics, which the company uses for so many of its toys, but we don't see any obvious reason for the shares to be up 6.3% since the last letter, or for that matter, 28% for the year. Maybe it's because **McDonald's** is selling so much fast food to kids who expect plastic figures and so forth with their Kids' Meals. MCD moved through \$40, up another 7%. **UPS**, which runs on gasoline and jet fuel, jumped 6.8%. Finally, **American International Group**, though not an energy play, certainly benefits from no hurricanes, since along with its competitors AIG in anticipation of future hurricanes ratcheted up rates in the wake of Katrina and Rita. What is nice about running an insurance company is that after a natural disaster, you can raise rates and your clients accept the added cost, because they can see the damage. Except, if you are a well-managed insurance firm, you already reserved for such an event out of past premiums, and the new premium structure gives you more reserves to invest profitably. AIG added 4.3%.

### **MEDIA AND TELECOM**

Media and communication shares continue their surge. **Comcast** added another 6.4%, **Time War-**

**ner**, which few seem to remember is second only to Comcast as a cable company, did even better, up 11.3% as Carl Icahn has revived his interests in making a quick buck off TWX. **The Discovery Channel**, one of the many spin-offs from **Liberty Media**, came to life as well, up 7.8%. No significant news about Discovery, but this one has been loitering for nearly a year, and perhaps is starting to attract an audience. **Liberty Global**, the international cable company that came out of Liberty Media, also added 7.7%. **Disney**, despite concern that DVD sales are slowing, kept pace with the sector, adding 6%. **AT&T (SBC)** continues to ramp, adding another 1.4%, bringing it to a 38% return year to date. **Gabelli Global Telecommunications Fund** is also moving again, up 4.6% this month. It's worth noting that we recommended most of these positions in a string of letters during 2002 not because we detected some grand theme but because they were just too cheap based on their historical valuations for us to ignore. Not all of them went straight up. Indeed, AT&T/SBC barely kept its head above water, buoyed up only by its strong dividend. Finally, it took off this year. **Telecom New Zealand**, which we recommended two months ago, tacked on another 1% after a 20% straight up move in its first month.

### **REITs**

**Friedman, Billings, Ramsey**, the hybrid mortgage REIT and investment bank/brokerage, has disappointed, especially now that it has slashed its distribution to a nickel a share. We erred in believ-

ing that FBR could tough out its mortgage-backed portfolio and still maintain the dividend. We've seen pessimistic calculations that value FBR at just under \$9 a share, which presumes that the mortgage-backed securities portfolio that once generated its fat dividend is worth close to zilch. If that is the case, FBR is now at a bottom, hardly the time to sell despite the pain inflicted on the way down. For the month, however, FBR is up 4.9%. We are moving FBR to the Aggressive section of our portfolio. Outside the mortgage REIT sector, however, Real Estate Investment Trusts are confounding expectations by forging ahead for yet another year. **HRPT Properties Trust**, which we pointed out when it was languishing in the low \$10s is up 20.1% for the year, but stumbled, giving back its intramonth rise, when management announced recently it would issue \$332 million in convertible preferred shares. The conversion price is \$13. Investors don't like to see new debt, even when a company like HRPT Properties has invested it profitably. We continue to consider HRP undervalued. **Senior Housing Properties**, which years ago HRPT spun off, is up 36% for the year, and 3.6% since the September letter. **Crescent Real Estate**, which offered the fattest distribution of all our REITs, is up 18% and is rumored to be an acquisition target. Speculation drove CEI last month, and since then it's just hanging around, and is unchanged since the September letter. Don't jump on it now, since we think expectation of a buyer emerging already has put most, perhaps all, of any purchase premium into the share price. **SA**

# Sound Advice: Portfolio for October 2006

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$11.59	7.25%	\$12.40	BUY
Senior Housing Properties	SNH	NYSE	\$21.66	5.72%	\$21.00	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$27.58	0.40%	\$29.00	BUY
American International	AIG	NYSE	\$67.02	0.75%	<b>\$70.00</b>	BUY
AT&T	T	NYSE	\$31.78	3.94%	\$33.00	BUY
Coca-Cola Enterprises	CCE	NYSE	\$20.65	0.77%	\$24.00	BUY
ConAgra	CAG	NYSE	\$24.99	4.37%	\$26.00	BUY
CSX Corporation	CSX	NYSE	\$33.71	1.19%	\$35.00	BUY
Disney	DIS	NYSE	\$31.34	0.77%	\$34.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$40.39	0.35%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	\$49.05	0.69%	N/A	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	\$16.73	0.00%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$20.32	0.00%	N/A	BUY
Getty Images	GYI	GYI	\$48.43	0.00%	\$49.00	BUY
Honeywell	HON	NYSE	\$42.31	1.77%	\$45.00	BUY
Johnson & Johnson	JNJ	NYSE	\$65.06	2.03%	<b>\$69.00</b>	BUY
Liberty Capital	LCAPA	NASDAQ	\$86.15	0.00%	\$90.00	BUY
Mattel	MAT	NYSE	\$20.20	1.98%	<b>\$23.00</b>	BUY
McDonald's	MCD	NYSE	\$40.11	0.57%	<b>\$44.00</b>	BUY
Molson Coors Brewing	TAP	NYSE	\$65.87	1.24%	\$72.00	BUY
Newell Rubbermaid	NWL	NYSE	\$29.11	2.27%	\$31.00	BUY
New York Times Co.	NYT	NYSE	\$22.77	2.90%	\$27.00	BUY
Perrigo	PRGO	NASDAQ	\$17.42	0.57%	<b>\$20.00</b>	BUY
Safeway	SWY	NYSE	\$28.38	0.00%	\$33.00	BUY
Sara Lee	SLE	NYSE	\$16.49	2.43%	\$17.00	BUY
Schering-Plough	SGP	NYSE	\$22.06	0.91%	\$24.00	BUY
Sony	SNE	NYSE	\$37.78	0.60%	<b>\$44.00</b>	BUY
Superior Industries	SUP	NYSE	\$16.88	3.79%	\$23.00	BUY
Telecom New Zealand	NZT	NYSE	\$19.53	9.7%***	\$23.00	BUY
Tetra Tech	TTEK	NASDAQ	\$17.99	0.00%	\$20.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$59.62	2.58%	N/A	BUY
United Parcel	UPS	NYSE	\$74.27	1.13%	<b>\$78.00</b>	BUY
Wal-Mart Stores	WMT	NYSE	\$48.32	1.39%	\$52.00	BUY
<b>WisdomTree Dividend Top 100 Fd</b>	<b>DTN</b>	<b>NYSE</b>	<b>\$55.00</b>	<b>3.16%</b>	<b>N/A</b>	<b>BUY</b>
Xerox	XRX	NYSE	\$15.68	0.00%	\$18.00	BUY
<b>Energy/Natural Resources</b>						
American Cent. Gold Fund	BGEIX	800-826-8323	\$16.58	0.00%	N/A	BUY
Coeur d'Alene	CDE	NYSE	\$4.47	0.00%	<b>\$5.50</b>	BUY
EnCana	ECA	NYSE/TSE	\$45.49	1.32%	<b>\$52.00</b>	BUY
Icon Energy Fund	ICENX	800-764-0442	\$30.81	0.00%	N/A	BUY
Phelps Dodge	PD	NYSE	\$84.56	1.18%	<b>\$92.00</b>	BUY
Plum Creek Timber	PCL	NYSE	\$34.57	4.17%	\$41.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	\$64.82	2.05%	\$70.00	BUY
Transocean	RIG	NYSE	\$69.28	0.00%	<b>\$75.00</b>	BUY
<b>Aggressive Growth</b>						
Comcast	CMCSA	NASDAQ	\$37.13	0.00%	<b>\$40.00</b>	BUY
Crescent Real Estate	CEI	NYSE	\$22.07	6.80%	\$22.50	BUY
Discovery Holdings	DISCA	Nasdaq	\$14.74	0.00%	\$17.00	BUY
Electronic Data Systems	EDS	NYSE	\$24.28	0.82%	\$30.00	BUY
Friedman, Billings, Ramsey	FBR	NYSE	\$8.37	9.56%	<b>\$9.00</b>	BUY
Liberty Global	LBTYA	NASDAQ	\$26.20	0.00%	\$29.00	BUY
Mitsubishi UFJ Financial	MTU	NYSE	\$13.08	0.73%	<b>\$16.00</b>	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$5.79	5.70%	N/A	BUY
Time Warner	TWX	NYSE	\$18.78	0.00%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$20.82	0.00%	<b>\$25.00</b>	BUY
Western Digital	WDC	NYSE	\$17.12	0.00%	\$20.00	BUY

\*Prices as of the market close on Friday, October 6, 2006

\*\*Yield represents all distributions during current calendar year divided by share price.

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

# Sound Advice: Market Indicators for October 2006

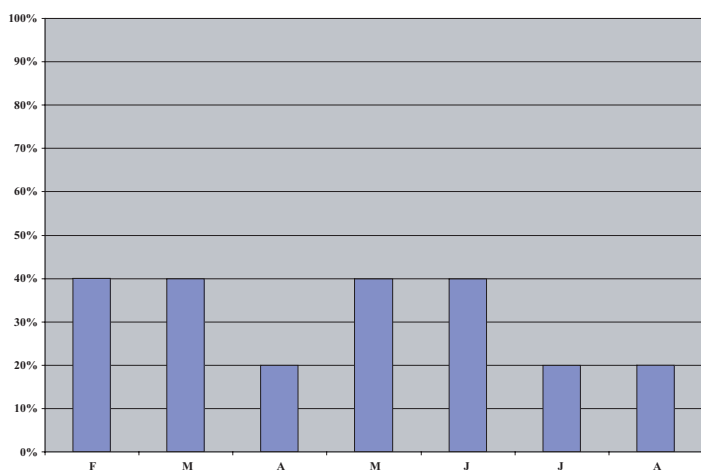
*Sound Advice* depends on three trustworthy indicators to determine our investment direction. The **Risk Indicator** (see inside front cover) measures investors' interest in real estate compared to stocks. Currently we see that the stock market is significantly overvalued versus real estate. The **Leading** and **Lagging Indicators** track the direction of the U.S. economy. We want to be aggressively buying the broad market when these indicators signal the economy has slowed, cautiously selective when counter trends exist, and out when storm warnings are up. The charts and explanations are updated monthly. To see how far ahead the Indicators would have put us had an investor made decisions based on these Indicators, review the performance statistics to the right, and compare these results against how the Standard & Poors 500 has done.

START DATE	ANNUAL COMPOUNDED RETURN
JAN 2003	20.55%
JAN 2000	11.60%
JAN 1992	11.74%
JAN 1980	18.31%
JAN 1975	19.53%
\$25,000 invested in 1975 would equal \$6,957,381 today using our buy/sell signals	

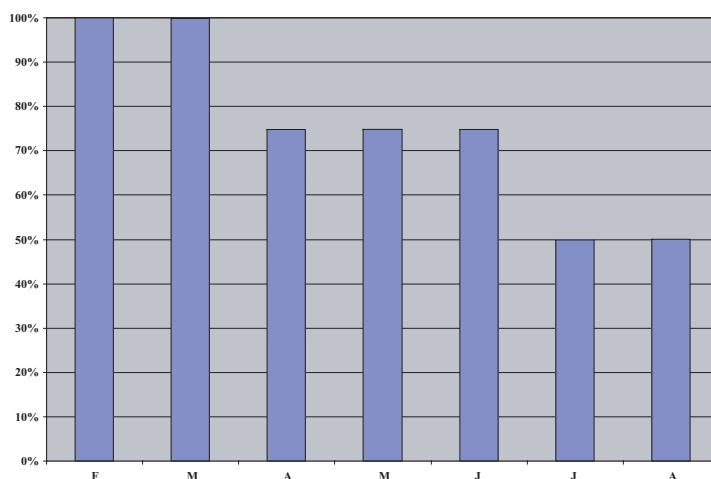
For years prior to 1992, the return percentages are calculated by purchasing the Twentieth Century Growth Fund on buy signals and investing in money market funds on sell signals. Following January 1992, the calculated returns assume funds were switched to the Sound Advice Model Portfolio. Signal Performance: 6.36 times better than the overall market since 1975. We recommend confining your investments to our portfolio selections.

The Diffusion Index of Leading Indicators chart compares each of five leading economic indicators with its level of six months earlier. A value of one point is given for each indicator that rises, one-half point for each unchanged, and zero for each indicator that drops. The sum of these points is divided by five and converted to a percentage. Buy signals are generated at zero readings, when all five leading indicators have fallen below their levels of six months earlier, revealing that the economy has softened sufficiently to cause a lasting decline in interest rates. Currently, the Diffusion Index of Leading Indicators stands at 20%. The Diffusion Index of Lagging Indicators chart is calculated in the same fashion. It generates sell signals when 100 percent of its four lagging indicators rise above their levels of six months earlier, revealing that the economy is heating up enough to cause a lasting rise in interest rates. **The Diffusion Index of Lagging Indicators in October hit 100% based on figures from The Conference Board. This constituted a Sell Signal.** Though this Index has fallen back to 25%, the Sell Signal remains in force as a caution light for us. We recommend avoiding the broad market, and restricting your portfolio to positions recommended in *Sound Advice*.

**Leading Indicators**



**Lagging Indicators**



**NEXT ISSUE MAILES ON NOV. 10TH**

ing calls, or owning shares in refiners and shares in airlines. Under normal circumstances, when one prospers, the other craters. Instead, Amaranth let its energy trader run wild. And he did it with borrowed money.

One other thing. Had Maounis asked any knowledgeable gardener, he would have learned that Amaranths are real blooms favored because despite not being eternal (in fact, they are relatively short-lived), they hold their color nicely when dead. Just like the stories of the soon to be dissolved Amaranth Advisors.

### **WHAT TO DO NOW**

Implicit in our opening comments about energy and other natural resources, we think you should hold on, and, if you are feeling bold, put more into them. We

like how our consumer staples are doing, and expect if the U.S economy is weak, for them to continue. Check the other sectors we highlight in the Updates section (page 8) for ideas.

Also, if you like bargains, please turn to the front page and read our new offer that extends subscriptions for six months at no added cost when you choose to receive *Sound Advice* via email on the Friday we publish. No delays, no issues shredded by the USPS. All you need is an Internet connection. Back issues will be archived on the *Sound Advice* website.

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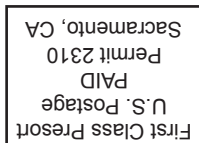


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