

# SOUND ADVICE

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Ford Convertible Cumulative Preferreds, after a near death experience earlier this year, have surged more than 900% from their low as it became clear that Ford not only would not follow GM and Chrysler into bankruptcy but also will prosper once demand picks up. For anyone with the moxie to have bought Ford on the way down—forget about the bottom—the returns have been spectacular.

But what can we say about persistent investor interest in the shares of the Old General Motors, the tatters remaining after bankruptcy court transferred assets with any value to the New GM? Since the new shares (ticker MTLQQ.PK) began trading on July 15th, volume has averaged more than 38 million shares a day.

Is there hidden treasure that the bankruptcy court overlooked? Is it a thrill to buy and sell thousands of shares but have just hundreds of dollars at risk? Do these buyers hope for a repeat of the Ford reversal of fortune? Frankly, that is as likely to pay off as buying tickets for Michael Jackson's next performance.

They're playing Russian roulette, pulling the trigger and hoping for the best while the shares suffer their death throes. Penny stock promoters and websites keep the pot boiling. "Piknikie," asked on July 20th "What do you think MTLQQ will do tomorrow?" Another touted it as "the next Citi." Federal regulators have warned that MTLQQ is valueless, because anything that could be sold represents a pittance compared to the the debts this putrid "business" still has on its books, but so what? If the market is just for thrills, MTLQQ is the macabre best.

—Gray Emerson Cardiff

## We Stayed in May

Wall Street loves its snappy nuggets of wisdom derived from questionable observations such as the market always declines between April 30th and October 31st, hence the old Wall Street saying "Sell in May and Go Away". To the contrary, in these pages of *Sound Advice*, our indicators were turning positive. As far back as March, very close to the bottom, we were projecting an upward turn in the market, a turn that not only marked a new business cycle, but a a new supercycle as well that will encompass several expansions and contractions in the economy. Our indicators confirmed that projection in May, flashing an "Agressive" buy signal (see page 10).

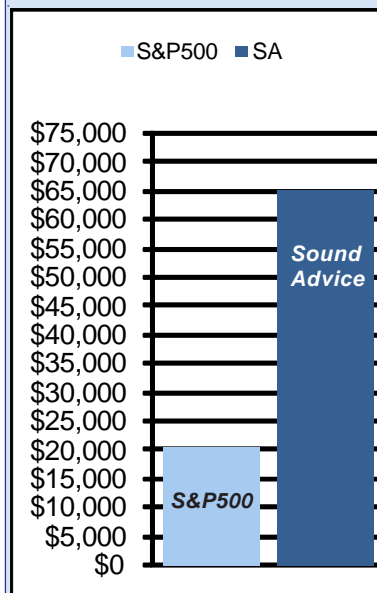
Had you booked the recovery profits that had accumulated in the Wilshire 5000 between March 9th and the end of April, you would have protected a 16.7% increase. Had you not heeded the "Sell in May and Go Away" wisdom, you would be 30.6% better since then and in total up 52.4% since March 9th.

The market's rush higher has not been unbroken. By our measure we're now in the sixth rally attempt to break the bear market dating back to October 2007. As each previous run petered out, bears and even penitent bulls cowed into submission by the worst market decline of our lifetime celebrated the end of another counterfeit rally. *Sound Advice* had been in caution mode since March of last year.

That this has been the most robust rally so far means nothing to the bears. That this rally has occurred amid signs that the U.S. economy is stabilizing means nothing. Bears, like knee-jerk bulls in rising markets, continue to press their bets until they are wiped out.

*Sound Advice*, which is fully invested at all times, has been constructive about this latest surge,

### Sound Advice Versus the S&P 500



Since 1-1-2000, an Investment of \$25,000 becomes: \$20,502 with the S&P 500, for a loss of \$4,498, or \$65,415 with *Sound Advice*, for a gain of \$40,415, a difference of \$44,912 (180 percent of the investment)

## "Be Greedy When Others Are Fearful"

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but we also were confident enough throughout the bear market to buy what we perceived to be opportunities, even when it was extraordinarily painful to recommend a new investment, or more painful still, to advise buying more of what had been cut in half or worse. Frankly, when we described the freefall in REIT shares in late February to be a panic worsened by artificial selling pressures, or advised that Ford, despite what was happening at GM and Chrysler, remained a speculative buy, we wondered whether we had allowed stubbornness rather than resolve to take control.

At this point, whether it was stubbornness or resolve, staying in the market is paying off. As Warren Buffett, who as his multibillion dollar buys into Goldman Sachs, General Electric and other beleaguered American blue chips while the bear market fell further into the red, had observed last October: "Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now." Buffett was mercilessly ripped in the financial media, and as has been the case everytime he was buying when others were selling, he is getting the last laugh.

We devote this month's issue to our funds, which though they account for a quarter of the *Sound Advice* portfolio, tend to get short shrift because they are too simple and too complicated. They are simple because their results represent the blended performance of many individual investments. Superior performance means the manager is doing a good job (or has been lucky). Inferior performance means the manager is doing a poor job (or has been unlucky). But once you go beyond gross performance and the managers' general orientation and peer into the portfolios, it gets complicated. As a group, the ten funds in the *Sound Advice* portfolio are up year to date on average 12.9%, though in fairness, we should exclude the short-oriented **Prudent Bear Fund**, which is down 11.7%. Without BEARX, the nine long funds are up 15.6%, which more than doubles the performance for the Dow and is 30% better than the S&P. They do lag the techcentric Nasdaq by more than a third. The entire *Sound Advice* portfolio has outperformed them all, up 33.3% to date for 2009.

We last gave a concentrated look at our funds 12 months ago after the market had recovered somewhat from the collapse of Bear Stearns and before the real bear market took hold. The Dow had recouped 7% and the Nasdaq 10%. We, like most value-oriented investors at the time, deemed the market far more attractive than it had been for quite a while.

As it turned out, it would get a lot more attractive as Bear proved to be a relative breeze before the gale hit in September with Fannie Mae and Freddie Mac falling into conservatorship, the forced acquisition of Merrill Lynch by Bank of America and the almost simultaneous collapses of Lehman Brothers and AIG, which quickly were followed by take-overs of Washington Mutual by JP Morgan and Wachovia by Wells Fargo. Finally, though we did not know officially until last December, the U.S. economy had been in recession since December 2007. Despite evidence that the economy has seen the worst, we are still in recession.

It's worth taking apart five of our funds to see how their managers confronted adversity. We'll cover the rest in the October issue. One we won't discuss in detail is the **WisdomTree Dividend ex-Financials Fund (DTN—NYSE)** originally named the **Wisdom Tree Dividend Top 100 Fund**, an ETF we had recommended as an intriguing way to buy undervalued stocks identified by their high relative yields. It presented itself as a variation on the Dogs of the Dow strategy, which forces investors to buy shares in companies whose dividend yields had risen in proportion to the drop in share prices.

The vicious bear market had been especially hard on DTN, because its screening methods by mid-2008 resulted in huge exposure to financial services shares. When we reviewed the fund last year, we noted that financials had vaulted to 43.3% of the DTN portfolio. Given what followed, excruciatingly poor performance through late February was inevitable. Since then, however, the market rally has featured financials, which should have supercharged DTN.

But that did not happen. Though DTN for the year is in the black, it missed the sweetest part of this rally because WisdomTree decided ten weeks ago to drop all financial services shares from its portfolio, something that it completed at the start of last month. Hence the change of name. What must be considered a marketing decision is not merely poor strategy but a betrayal of the fund's investors. Thus, we are removing DTN from our own portfolio, and cannot trust any WisdomTree fund to honor its model. We remain constructive about where this market is heading. **SA**

# Funds

**Dodge & Cox Stock Fund (DODGX)**, the flagship of this five-fund company, is down 23.2% since the August 2008 letter and up 18% for the year. As management noted in its annual report for 2008 (and could have been speaking for almost all value-fund managers): “we clearly underestimated the worsening credit crisis, the likelihood of government interventions, the depth and breadth of the ongoing economic problems, and the combined effect of these on many of the Fund’s holdings, particularly within the Financials sector.” To put some detail to this broad mea culpa: among the fund’s eight positions that had been doubled in size since the start of 2008 and before the financial crisis took the market down deep, five were in financial services, and each proved to be a disaster: AIG, Wachovia, Citigroup, SLM Corp and Wells Fargo. Of these, the least wounded has been Wells Fargo, which is down 5%. For the others, the “best” performer has been Sallie Mae, down 43%.

It is hard to grasp how great financial institutions like these could be vaporized seemingly overnight. In many cases, banks and investment houses turned out to be only as durable as others perceived them. Marty Whitman (see below) asserts that Bear Stearns was brought down by nothing more complex than a “run on the bank,” engineered and amplified by short-sellers, that destroyed confidence in the company. Doubt about Bear’s ability to borrow bloomed into the fear that if it couldn’t borrow, it was not credit worthy.

Not only did the per share net asset value of DODGX plummet along with the market, but massive redemptions, as shareholders fled to cash, shrunk a fund that had a total asset value of \$54.4 billion at the end of March 2008 to a total asset value of \$26.4 billion 12 months later. Over that period, shares lost 45% of their NAV.

Value investors almost invariably are fundamentalists, looking at balance sheets, and statements of income and cash flow to guide their selections. Dodge & Cox has been considered particularly adept. Last year’s debacle, frankly, is the down side of this approach. The irony of investing—and especially value investing—is that when the market is most inhospitable is when the biggest bargains are to be found. How gloomy things looked when the market closed on March 9th. Dodge & Cox by instinct and discipline saw the bear market, as it has in past cycles, as an opportunity. Had it abandoned its value approach, any expectation that it

could recoup its losses would have vanished.

Looking at the portfolio by sectors as of June 30th, we see that management has not maintained positions in financial stocks, though as a percentage of the portfolio they have shrunk from 16.9% (versus 14.3% in the S&P 500) to 11.2% (versus 13.6%). Healthcare, which when we discussed DODGX last August had the biggest weighting (21.5% versus 11.9%) has expanded to 26.9% versus 14%. Consumer Discretionary stocks also continue to be emphasized at 17.2% of the DODGX portfolio (versus 9%). Materials, which were underweighted versus the S&P in 2008, became even lighter in the most recent tally of sectors. Though DODGX managers do not indulge in regrets, not putting more emphasis earlier in the year in mining and materials stocks, we suspect, they would concede was an error.

It’s more important to look at specific positions to grasp how management worked at reshaping the portfolio. For example, though overall energy holdings were reduced, there were cross currents. Thus, holdings in multinational energy companies either shrank (Chevron, Occidental, Royal Dutch) or were liquidated (Conoco Phillips), but energy service positions grew (holdings in Schlumberger increased by 166% and Baker Hughes by 49%). Though firms with exposure to finance were reduced, General Electric, which had been dominated by its finance arm, grew in terms of shares by 152% and accounted as of March 31st for 2.4% of the portfolio, up from 1% 12 months before.

As for healthcare, the fund acknowledges political risk that has depressed share prices in this broad sector, but echoes what we have said in these pages: the values are compelling precisely because the market is too short sighted and exaggerates the risk.

For instance, the position in **UnitedHealth Group** expanded by 150% since we looked at the fund in 2008. DODGX is not interested in these companies as defensive positions. To the contrary, the fund moved out of or reduced exposure to other positions considered defensive such as McDonalds. The emphasis with DODGX always starts with how cheaply valued a stock is.

If a subscriber asked us which single investment in our portfolio they should buy and hold forever, it would be the Dodge & Cox Stock Fund, since its approach to investing hews closely to our own, which explains how

## Sound Advice on Funds: Part I

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10 of its 81 positions we hold currently.

**Third Avenue Value Fund (TAVFX)**, though generally classified as a large cap value fund, holds only a slight resemblance to DODGX or other traditional value funds.

TAVFX looks at value as a function of credit strength and tries to ferret out assets whose value is hidden from casual examination. Whitman gives macroeconomic considerations almost zero importance. During the chaos that started with the demise of Bear Stearns, Third Avenue found extraordinary opportunities. As Marty Whitman, who founded the fund and whose investing method underpins the portfolio, observes in a recent interview: “I had never seen pricing as attractive as we saw last fall and this winter for performing loans – the type of distressed asset we prefer. We acquired debt with an 80% to 95% probability of yielding 25% or more to maturity or to an event [e.g., the bond being called]. In the 5% to 20% chance that we were wrong, and there would be a money default, we would still be okay in a reorganization. Pricing like that was never available before.” More than any other investor we know, Whitman insists on making his money at the buy point, since he insists on buying only securities that he considers selling well below what he calculates their current value is.

But to find these deals requires looking beyond the obvious metrics, which means analyzing assets of companies with complex structures. For example, Whitman likes holding companies, which we also favor (**Leucadia** is a recurrent part of the *Sound Advice* portfolio, for instance) because they often contain unrelated businesses that Wall Street finds difficult to value fully. In the right situations, the sum of their parts is worth more than the whole’s share price. Eventually somebody notices.

He also likes insurance companies, which benefit not just from using their insureds’ premiums for investments but also hold assets worth more than they appear on their balance sheets. Whitman also favors real estate, especially when it is held for a long period of time and/or is not yet used for its highest value. Third Avenue repeatedly has found such opportunities abroad, particularly in Asia.

Third Avenue’s portfolio 12 months ago owned holding companies that accounted for 22.4% of assets, and the portfolio’s single largest position (\$838.4 million or 9.4% of the portfolio) was Cheung Kong Holdings Ltd., a Hong Kong holding company.

In fact, 70% of TAVFX’s holding companies are

domiciled in Hong Kong. The Asian influence runs much, much deeper. Non-U.S. real estate companies, which account for another 15.6% of the portfolio (nearly double what TAVFX had in U.S. real estate firms), are either in Hong Kong or Japan. Other Asian investments include non-life insurance companies (4.4%), all of which are Japanese. Exposure to metals comes in the form of a steel company—Posco of South Korea. More than half of Third Avenue Value Fund’s portfolio is domiciled in Southeast Asia. In the April 30th letter to shareholders (<http://www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-09Q2.pdf>), there’s an outline of each Hong Kong real estate and private equity position and a table setting out credit strength and how each is priced relative to what TAVFX are their net asset values.

Unlike most value funds such as DODGX, Third Avenue during the financial sector meltdown did not experience losses from the prominent financial services companies. “TAVFX did not own any securities issued by Bear Stearns, Lehman Brothers, Countrywide, Fannie Mae, Freddie Mac, Wachovia or AIG. As far as we are concerned, the Fund’s poor 2008 performance is attributable to an irrational stock market, not any fundamental deterioration in the businesses in which TAVF has invested.” Nonetheless, by March 9th of this year, TAVFX had dropped 36.6% from where it stood when we last reviewed the portfolio a year ago, but this year it is up 28.3%. For buyers since the March 9th low, the shares are up 67.2%.

This fund marches entirely to its own value-oriented beat, and gives individual investors the benefit of Whitman’s smarts and discipline.

**Dodge & Cox International Fund (DODFX)**, a relatively recent addition to the Dodge & Cox stable (it debuted in May 2001), follows the same bottom-up approach the flagship Stock Fund pursues. Since the domestic sibling can hold up to 20% of its portfolio in foreign companies, it is no surprise that the two funds share several prominent companies. The two funds also share a bias toward healthcare stocks, particularly pharmaceuticals. For the international fund, pharmaceutical companies fill three of the ten positions (Novartis, Sanofi-Aventis, GlaxoSmithKline). Each has a significant role in DODGX’s portfolio.

It is also not surprising that like the domestic stock fund, the International Fund last year committed the same fatal mistake of overweighting financial stocks in 2008. DODFX’s managers at the end of 2007 when value funds as a group thought the sector worth

## Sound Advice on Funds: Part I

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overweighting wrote: “In our opinion, current valuations [for financial services and real estate] reflect significant pessimism about asset quality and the long-term earnings power of these companies and represent an interesting investment opportunity over the next three to five years.” DODFX acted on that perception, and by mid-2008, after the Bear Stearns collapse but before Lehman Brothers bankruptcy let the hounds of hell loose, the fund had gone from an 8% underweighting in financials compared to the MSCI EAFE Index (Europe, Australasia, Far East) at the end of 2007 to a 5% overweighting .

Consequently, DODFX had a terrible 2008, ending down 46.7% versus the MSCI EAFE, which dropped by a mere 42.2%. In addition to wounds from overweighting financials, Dodge & Cox also hemorrhaged money from an overweighting in emerging markets, as skittish investors dumped them mercilessly last year and up to March of this year. Like its domestic sibling fund, DODFX late last year and into this did lighten up on financials but loaded up on emerging markets. In March 2008, the fund held 15.8% of its portfolio in Latin America (7.1%), Asia ex-Japan (5.5%), the Middle East (0.3%) and Africa (3.1%). As of June 30th of this year, that exposure has almost doubled: Latin America (6.9%), Asia ex-Japan (7.6%), the Middle East (0.3%) and Africa (6.2%). Doubling down on bets that go sour can be a sign of desperation. It also can be, as here, a demonstration of confidence in the discipline that until last year had produced excellent annual returns. So far this year, that confidence has been rewarded. DODFX is up 31.9% while the MSCI index has advanced 15.9%.

Two hallmarks for Dodge & Cox funds are low expenses and ultra-low turnover. Once a D&C fund initiates an investment, falling stock prices, provided the managers judge nothing substantive has changed, encourage more buying. With value investing patience is paramount. DODFX has a 0.64% expense ratio, while international value funds average 1.37%. But turnover during the past year has been extraordinary, at least for a D&C fund. For the last 12 months, it’s run at 35%, almost triple its historical average. But given how the fund has rejiggered its holdings, 35% is modest, especially when compared to its peers.

Funds that invest internationally face not just company-specific risk but also contend with currency risk. DODFX’s charter allows it to hedge its currency

exposure, though from inception until last year, it did not hedge, which when the dollar is weakening is a plus and a minus when it is strengthening. As of its last report to shareholders, DODFX signaled it had no hedges in place.

Unlike sector funds that *Sound Advice* recommends for specific market conditions, any Dodge & Cox fund and any Third Avenue fund, we feel, is a cornerstone investment that should be owned regardless of market conditions. Over time they have provided extraordinary performance. We see no reason to alter our opinion after the distress of the past two years.

### Icon Financial Fund (ICFSX)

stands between the pure managed funds like DODGX and ETFs that reform their underlying indexes at least once a year. ICENX belongs to a family of mutual funds that depends on an investing model derived from the work of Benjamin Graham, the patron saint of value investing. When it works best, these funds benefit both from traditional value

and from momentum, an unusual hybrid that, we must admit, we are coming to be skeptical about.

Unlike most value investors in search of companies whose shares are declining or are stagnant for an extended period, Icon looks for sectors that not only are undervalued according to its proprietary model but also are showing relative strength over the previous six months, that is, they are not in decline relative to the rest of the market. Icon believes that when sectors assert themselves, they will remain relatively strong for up to two years.

One consequence of shifting sectors is a high turnover rate as the manager shifts entire groups of stocks in or out of the portfolio. *Sound Advice* instinctively avoids fund managers with high turnover ratios, not only because constant buying and selling increases fund expenses but also because it implies indecisiveness. We estimate ICFSX’s turnover ratio approached 200%.

The problem in volatile markets such as we’ve experienced, particularly in financials for the past two years, is that no theme persists long enough to maintain the market’s interest. Thus, one month regional banks might be stronger because investors are preoccupied with the crises hitting money center banks, but when that crisis relents, they begin to worry about the

**"Be fearful when others are greedy, and be greedy when others are fearful...To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the longterm prosperity of the nation's many sound businesses makes no sense.**

*Warren Buffett, October 2008*

## Sound Advice on Funds: Part I

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consequences for regional banks, and down goes that sector.

For example, last year at this time, the fund between September 2007 and March 2008 had increased its Diversified Banking holdings from 10.8% of the portfolio to 14.8% , but after this sector had plummeted during the debacle that exploded starting with the fall of Lehman Brothers, the manager then reduced his exposure as of March 31,2009 to 2.5%. Now automatically excluded from the portfolio, these shares went on a tear.

Though this was the most dramatic and feckless move, there were others that have soured us on the quantitative approach Icon uses. Accordingly, we will be dropping not just this fund from our portfolio but its sibling in the energy sector, and will use the September issue to provide replacements. Hold them till then. It's not that the fund has failed to meet its benchmarks (compared to XLF, the iShares financial services ETF, it has run even with it. We feel, however, that our subscribers expect something better than index-fund performance from our recommendations.

**CGM Realty Fund (CGMRX)** put on quite a fireworks show between 2003 and 2007 (+89.7%, +35.5%,+27%,+29%,+34.4%) thanks to Ken Heebner, who has run the fund since inception in 1995. Heebner, aka "The Mad Bomber" has never been considered cautious.

But he went to a new level during his boom years by stocking his fund with not just Real Estate Investment Trusts (REITs) and Real Estate Operating Companies (REOCs), the typical fare, but invested heavily first in home builders, a natural extension of the real estate concept and then in mining companies, which was something of a stretch. His justification for mining shares, aside from his real reason that demand from Asia, China in particular, for metals was about to explode, was that mining companies own land, therefore they qualify as real estate investments.

The fund's results during those years silenced critics who said Heebner was taking his shareholders far beyond what anyone before had considered real estate, especially when mining companies and fertilizer companies dominated the portfolio.

All this worked beautifully until late summer of 2007 after REITs' seven year run ceased and natural resource stocks followed just as catastrophically, taking CGMRX went from top dog among real estate funds to an unloved stray.

We've owned the fund in the past, got out when Heebner stretched the portfolio, and last December,

when we felt REITs were ripe to recover, reintroduced it to *Sound Advice*. Though as we've seen, REITs had one more catastrophe to survive, CGM Realty has outpaced its benchmarks since the December issue, and is up 29.1% versus RWR, the iShares ETF, which is up 23.7%.

Heebner has been making significant changes in his portfolio, even if it's back on its leash with only 2.9% of assets invested in two precious metals miners. REIT holdings are concentrated in 17 companies, but Heebner's zest for going more boldly or going where others won't remains evident.

From a sector perspective, the biggest change over the last 12 months is the quadrupling of exposure to Mortgage REITs (21.8% of the portfolio) and hefty cuts in Office and Industrial (down 58%) and Apartments (down 67%).

The outsized bet on Mortgage REITs is pure Heebner. The anchor position remains as it was last year: Annaly Capital Management, which at an \$8-billion market cap dominates the sector, but Heebner has added positions in four smaller mortgage REITS, suggesting he believes the worst of the credit and housing crises are over and that not only will the assets these REITs hold continue to perform but that they are undervalued.

As for other significant changes, though portfolio exposure to retail has increased only from 30% to 32%—still the largest sector exposure for Heebner—the mix of specific REITs has changed significantly. Gone are General Growth Properties, which is among the most prominently overleveraged REITs and Kimco, one of the largest strip mall operators. To replace them, Heebner added Developers Diversified Realty and expanded his holding in Macerich. Developers Diversified faced some of the same challenges General Growth did but has been able to reduce debt on its balance sheet by selling properties, issuing more shares and substituting distributing new shares in lieu of 90% of its dividend.

Macerich is in a better shape than DDR but compared to other retail REITs the fund owns is relatively risky. Heebner is willing to buy into a real estate sector at the heart of a consumer recession, and as with Mortgage REITs, mixes strong with weaker companies, wagering that in a recovery all will rise but the questionable positions will explode.

Compared to other REIT fund managers Heebner either outperforms or underperforms. However, his good years more than make up for the bad. In a recovering market, his fund should shine. **SA**

## Portfolio Updates

The July issue was priced on July 10th, with stock prices down about 7% from the June highs. We remained optimistic but conceded we had no idea when the rally would resume. Would you have believed us if we'd said that this was the low and that share prices were primed for another big run? It was, and they did. The Dow is up 15.9%, the S&P 14.9%, the Nasdaq 13.9% and the pan-market Wilshire 5000 15.7%. The *Sound Advice* portfolio added 17.8%.

The healthcare stocks, highlighted in the July letter, had mixed earnings reports. **UnitedHealth**, the HMO, reported slightly better than expected results, the consequence of higher rates and an increase in its public sector membership (Medicare, Medicaid), though there was a small decline in private membership. UNH, as good companies do when times are tight, has been able to reduce operating expenses, dropping them by 14%. The elephant in the room, of course, remains what Washington will do about reforming healthcare. As you know, we had staked out a contrarian perspective that anticipates reform but does not expect it to be devastating. The key for the medical insurers is, does Congress pass laws to establish a public healthcare plan? If it does, HMO shares will sell off and have a harder time recovering (they will eventually). But if, as it now is tending to seem, something other than a public plan emerges, perhaps a cooperative system, perhaps nothing, we should see a boost in UNH shares. UNH also continues to expand. This time it has bought from Health Net, a rival HMO, its northeastern U.S. operations. This adds about 358,000 members, not a huge increase to UNH's existing 30 million clients, but a chance to apply its economies of scale to bring down operating costs. UNH is up 7.5%.

As the market heated up and investors sought growth-oriented themes, money flowed into stocks tied tightly to a cyclical economic recovery, leaving healthcare companies, which generally are not, alone.

One exception was **Odyssey Healthcare**, the hospice care provider that announced quarterly numbers that extended the Q1's solid results. Integration of its newest acquisition helped, but something more is happening

here. Since the last letter, ODSY is up 26.6%, almost all of it occurring before second quarter results were announced. Medicare estimates that it incurs 25% of its annual costs during each client's last 12 months, most

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of it for care in hospitals. Hospice care, either at home or in a care facility, is a humane and less expensive alternative when heroic medical efforts cannot hold back death. The Bush administration tried to make hospice care more accessible by modestly raising reimbursements, and the Obama administration also wants to make hospices a central part of how society faces end-of-life issues. In the funny house of mirrors that is politics, however, government encouragement of hospices is being caricatured as stealth euthanasia. Regardless, Odyssey's strong performance suggests that hospice care holds a favored place in the future.

**Boston Scientific** reported stronger than expected results, driven by better sales of stents and cardiac rhythm devices. BSX continued to own half of the stent market in the United States, a remarkable feat given that Abbott Labs owns the newest drug-coated stent (Boston Scientific markets the same stent under its own brand through a royalty agreement). But BSX's own line of drug-coated stents continues to do well. The Guidant division, which had been in trouble with the FDA, is also back on track. Management announced new data on a cardiac resynchronization device that when implanted, usually for the sickest heart failure cases, reduced deaths and/or emergency interventions by 29% compared to existing devices. Boston anticipates FDA approval next year, and sees a half billion dollar global market for this product. All in all, a

# Sound Advice Portfolio for August 2009

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Duke Realty Cumulative Preferred	DRE.PRO	NYSE	\$23.60	8.87%	<b>\$25.00</b>	BUY
HRPT Properties	HRP	NYSE	\$5.75	8.35%	<b>\$6.50</b>	BUY
Public Storage Cumulative Preferred	PSA.PRM	NYSE	\$22.50	7.36%	<b>\$25.00</b>	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$49.12	0.22%	<b>\$56.00</b>	BUY
Boston Scientific	BSX	NYSE	\$11.32	0.00%	<b>\$14.00</b>	BUY
CarMax	KMX	NYSE	\$17.40	0.00%	<b>\$21.00</b>	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$18.72	4.38%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$28.88	7.80%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$86.84	2.10%	N/A	BUY
Fastenal	FAST	NASDAQ	\$38.54	1.82%	<b>\$46.00</b>	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$17.14	1.93%	N/A	BUY
Honeywell	HON	NYSE	\$36.38	3.33%	<b>\$42.00</b>	BUY
Johnson & Johnson	JNJ	NYSE	\$59.90	3.27%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$25.86	0.00%	<b>\$30.00</b>	BUY
Mattel	MAT	NYSE	\$17.88	4.19%	<b>\$20.00</b>	BUY
Microsoft	MSFT	NASDAQ	\$23.56	2.21%	\$26.00	BUY
Molson Coors Brewing	TAP	NYSE	\$45.43	2.14%	<b>\$52.00</b>	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$12.39	0.00%	<b>\$14.00</b>	BUY
Perrigo	PRGO	NASDAQ	\$26.77	0.82%	\$29.00	BUY
Sprint Nextel	S	NYSE	\$3.79	0.00%	N/A	<b>SELL</b>
Stryker Corp.	SYK	NYSE	\$40.21	0.99%	\$45.00	BUY
Superior Industries	SUP	NYSE	\$15.87	4.03%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$30.06	0.00%	<b>\$35.00</b>	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$42.16	0.44%	N/A	BUY
United Parcel	UPS	NYSE	\$54.11	3.33%	\$60.00	BUY
UnitedHealth Group	UNH	NYSE	\$26.51	0.11%	\$32.00	BUY
Wal-Mart Stores	WMT	NYSE	\$49.29	2.22%	\$60.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$36.40	5.15%	N/A	<b>SELL</b>
Xerox	XRX	NYSE	\$8.45	2.04%	<b>\$10.00</b>	BUY
<b>Energy/Natural Resources</b>						
Anglo-American PLC****	AAUKY.PK	PINK SHEETS	\$15.97	0.00%	<b>\$20.00</b>	BUY
Icon Energy Fund	ICENX	800-764-0442	\$15.77	0.74%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$35.09	4.79%	<b>\$40.00</b>	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$15.96	0.50%	<b>\$19.00</b>	BUY
Transocean	RIG	NYSE	\$75.06	0.00%	<b>\$82.00</b>	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$27.84	0.04%	N/A	BUY
<b>Aggressive Growth</b>						
Comcast	CMCSA	NASDAQ	\$14.96	1.82%	\$19.00	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$30.29	15.41%***	<b>\$34.00</b>	BUY
Icon Financial Fund	ICFSX	800-764-0442	\$5.58	0.00%	N/A	BUY
Liberty Global	LBTYA	NASDAQ	\$21.84	0.00%	<b>\$25.00</b>	BUY
Maxim Integrated	MXM.PK	NASDAQ	\$17.30	4.62%	\$19.00	BUY
Federated Prudent Bear Fund***	BEARX	800-711-1848	\$5.91	0.00%	N/A	BUY
Symantec	SYMC	NASDAQ	\$15.51	0.00%	\$19.00	BUY
Time Warner	TWX	NYSE	\$28.34	2.68%	<b>\$34.00</b>	BUY
Western Digital	WDC	NYSE	\$31.98	0.00%	<b>\$35.00</b>	BUY

\*Prices as of the market close on Friday, August 7, 2009

\*\*Yield represents all income during previous 12 months divided by current share price.

Note that all fund distributions fluctuate annually.

\*\*\*Dividend Deferred

\*\*\*\*Note change in ticker symbol

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

## Sound Advice: Portfolio Updates for August 2009

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very encouraging quarter that augurs well for the future. Since the last letter, BSX is up 17.6%.

**Stryker**, the orthopedic device and operating room equipment maker, added 7.3%, after announcing so-so results for the previous quarter. Poor results from its Medisurge division, which sells equipment to hospitals, is no surprise. Hospitals are postponing capital expenditures. At some point in a more prosperous future, hospitals must replace operating theatre equipment and hospital beds. SYK will benefit.

**Perrigo**, which we did not outline in the July issue, because we had given it the full treatment just the month before, was flat. We'll wait for the early August earnings report to comment.

**Johnson & Johnson**, the healthcare giant, reported OK results, which in part were hurt by weaker stent sales, the consequence of BSX holding its market share and Abbott increasing its. JNJ added 5.2%.

Thus, the biggest movers in the portfolio were business cycle sensitive sectors. Real Estate Investment Trusts are running strongly. **HRPT Properties Trust** added 45.7% including the 12 cent dividend. The market seems to have absorbed the sale of 51% of the assets spun off to create a new REIT, Government Properties Income Trust (GOV—NYSE), and continues to push REITs in general higher. **CGM Real Estate Fund**, which also went ex-dividend since the last letter (24 cent distribution), is up 43%. When you can get a 28.5% jump from a REIT preferred, as **DRE-PO** did, it is stunning evidence that Wall Street no longer is hanging crepe for REITs. The **Public Storage Cumulative Preferred** also had a good month, adding 11.9%. When we introduced these two preferreds last January, we made clear one was the more stable, nearly bulletproof investment, and it has performed exactly as advertised. Even at the worst moment for REIT preferreds, it dropped 22% from our January purchase price (that might sound scary but the Duke preferred at its worst had collapsed 61% under the weight of forced selling by institutional holders). In recovery mode, the Duke has had much more space to run. Since that January recommendation, the PSA preferred is up 16.3% and the Duke 46.8% including dividends. From the March low, the returns border on incredible.

If you want speculative how about **Ford**, which got a big jolt when “earnings” (more precisely, its lack thereof) came in better than anticipated at a loss of 21 cents rather than the expected 49 cents. Since the last letter, it's up another 45.3%. It is also now two dividend payments in arrears (= \$1.625, or 5.6% of the current price), and we are getting more confident those arrears

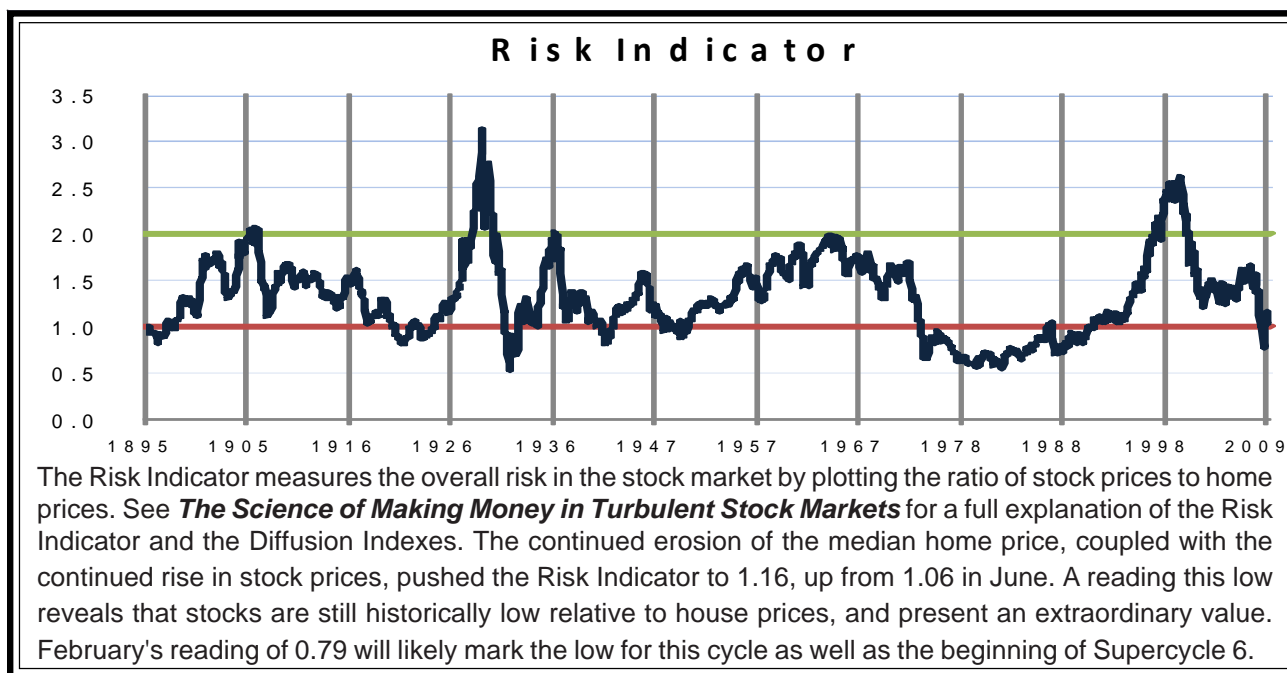
will be paid presently. We also believe the Ford preferreds should move higher once the economy returns to growth.

Of the 44 positions in the portfolio, three failed to advance. Not surprisingly, the **Prudent Bear Fund** dropped 8.7%, its bearish short positions tempered by its long positions in precious metals miners (**USAGX**, our precious metals fund, added 16.2%). The other dismissed stocks were **Symantec**, which unnerved Wall Street when it announced sales and earnings below expectations, explained by customers' preference for shorter contracts to conserve funds. Since the last letter, SYMC is down less than 1%.

**Sprint Nextel** was the third loser, down 13.1%. Sales results for the quarter met expectations but the earnings loss was worse than expected. Sprint continues to lose subscribers, but at a slowing pace. Reluctantly, we are selling S out of the portfolio, though it has more than doubled this year. Also, see page 2 for why we are selling the WisdomTree dividend fund (DTN). Finally, expect to see replacements next month for the two Icon funds, a decision explained on pages 5-6.

Natural resource stocks keyed off news of better economic conditions. **Anglo-American** is up 17.6%, **Icon Energy Fund** 14.9%. The **PowerShares Water Resources Fund** added 12.2% and **Tetra Tech**, which is a major holding in PHO's portfolio, was up 13.8%. **Agrium**, the Canadian fertilizer manufacturer, advanced 27.2%. **Transocean**, the deepwater driller, reported lower rig activity, consistent with what other drillers are reporting, which held the shares to an 8.7% rise. We suggest paying attention here, since RIG will see a reversal in demand once energy companies feel the need to pump up their reserves, **Plum Creek Timber** reported better than expected earnings but got a less than positive response. Still, shares rallied along with the natural resource shares, and closed up 23.7%. **Leucadia**, which as a holding company does is exposed to different things but tends to be perceived as essentially a mining company because of its holdings in an Australian iron ore producer and elsewhere, leaped 38.8%, most of which occurred before superb earnings were announced. Its holdings in financial services firms like Jeffries and AmeriCredit increased 58% in value. One tantalizing rumor has Berkadia, a partnership between Leucadia and Buffett's Berkshire Hathaway, trying to buy parts of troubled CIT. Earlier this decade, Berkshire supplied the credit and Leucadia the smarts to unwind Consec's tainted financing, which turned out very well. CIT rejected the offer. We expect something, if not with CIT then elsewhere. **SA**

# Sound Advice Market Indicators for August 2009



## The Sound Advice Diffusion Indexes

**The Diffusion Index of Lagging Indicators** gives “Caution” signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. This Diffusion Index currently stands at 0 percent.

**The Diffusion Index of Leading Indicators** gives “Aggressive” signals when all four of its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

As far back as February and March we were projecting that our Diffusion Index of leading indicators would hit zero in March, and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an “Aggressive” signal.

An “Aggressive” signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. See *The Science of Making Money in Turbulent Markets* for a history of Supercycles (which you received with your subscription). You will also receive an updated copy when you renew your subscription.

### 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 return of 20.5 percent. During “Caution” signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent.

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		

### Recent Strength

The hand-picked leading indicators that comprise our Diffusion Index of Leading Indicators, which are the most sensitive to changes in economic conditions, showed unusual strength in June, rising 6.8 percent over the prior month. This rise followed increases of 6.38 percent in May and 2.71 percent in April.

Such unusually high increases have occurred as we begin recovering from past recessions, and before the recovery was widely recognized. Although it is not indicative of the strength of the recovery, it is an indication that the worst is probably over.

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