

# SOUND ADVICE

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## What Does the Market Know?

Had I been writing this before the last Federal Open Market Committee meeting at the end of June, a possible title would have been “Saint Alan’s Successor Is Satan,” a shorthand way to say that as much as Wall Street loved Greenspan they hated Bernanke, because Mr. B keeps raising rates when everyone on Wall Street knows it would be best (for short-term benefits to investors) for the Fed to pause its steady drumbeat of rate increases. Now, despite the Fed having raised rates yet another 25 basis points to 5.25% for the 17th time in 24 months, Wall Street has decided again that the Fed really, really wants to pause. Why? Because in the 191 word communication that accompanied the rate increase announced on June 29th, the Fed’s language almost begs for a pause provided economic data permits.

Let’s summarize what had happened: after the Fed raised rates on May 10th, soothsayers decided the Fed wasn’t about to pause anytime soon, and the market went into freefall, especially the sectors that had been hottest for the previous three years: metals, both precious and industrial, energy, and emerging markets in Asia, Latin America, and eastern Europe. Tech, which had been weak even before May, went along for the ride.

Worse yet, not only had the Fed raised—no surprise—but Bernanke and other Fed governors in speech after speech harped on concerns about inflation, and how higher rates might be required to tamp it down. Rising interest rates hurt stock prices not just because higher rates make bonds and other income-oriented investments more attractive to equity investments but also because higher costs for money throttle down companies’ ability to borrow to grow and for consumers to borrow to consume. Another victim of rising rates are speculators, who played a significant role in driving these hot sectors.

Wall Street has been viciously critical of Bernanke,

accusing him of inconsistency in remarks about what the Fed intended to do, because the financial community read his early comments to mean that he would pause raising rates. When, instead, he continued to raise rates, and even specified the inflation threshold beyond which he would continue to move rates higher, the howls echoing through Wall Street’s canyons were shrill. Certainly, Bernanke did and does want to pause. But what Wall Street ignored in Bernanke’s earlier comments (and in his late June remarks) is that any pause must depend on what future data indicates. The data still points toward inflationary pressures.

On Wall Street in May and for most of June until the last FOMC meeting soothed the pain, Bernanke became a devil, especially compared to Saint Alan, who Wall Street believed could be counted upon to open the credit spigot anytime he sensed trouble for the markets. Forgotten was that Saint Alan created many of the conditions Bernanke now has to correct.

Unlike Saint Alan, who, for example, foolishly misread and trivialized rising energy prices, Bernanke specified

what worries him: commodity prices. “Cumulative increases in energy and commodity prices have been large enough that they could account for some of the recent pickup in core inflation.” In the same mid-June remarks Bernanke was even more concerned about the secondary impact of higher energy prices on the economy, that is, when energy users start to pass on those costs to their customers, and workers begin to seek higher wages merely to match costs that are rising as energy expenses get passed on. Bernanke believes that second wave has begun to roll.

However, we think that what tripped up the markets is not so much the prospect of rising rates here at home but the closing of the spread between foreign rates and our own, since it was not just in the U.S. that the prospect of higher interest rates rattled markets. Stock

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Finished in the Top Five Investment  
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exchanges around the globe starting in May went south fast, and for the same reasons: higher interest rates and other measures to rein in cheap money suddenly increased the riskiness of investments, especially leveraged investments that with borrowing rates low promised even higher returns but when rates reversed direction amplified the pain.

The clearest case is the Bank of Japan. Over the last few years, Japan's central bank, in order to stimulate its own torpid economy, effectively kept real interest rates (the nominal rate of interest minus inflation) at or even below zero, which created a virtual money machine for anyone who cared to borrow Yen and then buy a bond in the U.S., Europe, Australia, or anywhere else that had higher rates. It was all gravy.

Inevitably and invariably players in search of richer returns did not restrict themselves to safe U.S. Treasuries. They wandered further out along the risk curve, and were rewarded for wading into hot markets such as India and Turkey, and into hot sectors like metals and energy. And over time, they were leveraging their positions thanks to cheap money borrowed from willing bankers around the globe. Think of Japanese lenders as the financial markets' version of Chinese manufacturers: China exported cheap stuff, and Japan, and to a lesser extent other countries, exported cheap credit. Main Street and Wall Street gobbled it all up.

In March, Japanese central bankers signaled that real zero rates were no longer necessary to stimulate the economy. We expect to see Tokyo act on that conclusion, perhaps even before the July issue reaches you. Meanwhile, the rest of the world is already raising rates. On June 7th, Turkey's central bank for the first time in five years increased interest rates. On the next day, the European Central Bank, the Reserve Bank of India, the Bank of Korea, and the Bank of South Africa as well as the central banks for Denmark and Thailand all followed suit. Later in the month, Sweden raised its benchmark lending rate.

And then there is China, which is trying to limit speculative growth, especially in real estate, by instructing banks to increase their reserves for commercial loans, and to limit property loans. The



central bank also wants to restrict foreign investors' speculation. The delicate trick for China, like Goldilocks' goal, is to find what is hot but not too hot. China reports that its economy grew at a 10.3% clip during the first quarter of 2006 after posting a 9.9% growth rate for all of 2005. It is hoped that during the second half China will throttle back to a "modest" 9.9%.

So here is the problem: central bankers want to cool down their economies gently: not too much and not too fast. With China, because the level of growth has been so rapid, it might take more than gentle directions from Beijing to brake that train.

The drop in commodity prices and in emerging markets that hit in May and June, we believe, reflects that withdrawal of hot money. The \$64 question about these sectors will be answered over the next six months. Our view is that prices will not collapse, since, as we see it, demand is still robust and supply remains constrained. As for China's ability to restrain growth, we think China is more likely to err on the side of heat.

### ***SOUND ADVICE PORTFOLIO***

The June cover essay, "Commodities Bubble" argued for renewed strength in prices. There are several keys as to how the *Sound Advice* portfolio will fare in the short-term. We believe that oil prices will remain high, that natural gas prices will rebound as normal seasonal factors emerge, that other natural resources will respond to demand that outstrips supply by rising, and, as the dollar weakens due to the twin deficits and inflation insinuates itself further into the global economy, that

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

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We count many brokers among our subscribers, and applaud these men and women who, in their clients' best interests, look beyond what their companies prime them to promote. These days, no one's business card uses "broker." Instead, they are financial advisors, wealth advisors, financial consultants. Believe me, they are all still brokers: they funnel your money into investments.

Long ago, I was a broker until I realized I wasn't very good as an extension for a marketing machine that dictated what and how investments were sold. Marketers today run most of retail brokerage and the mutual fund industry, and they prefer the comfort of consensus, which is no way to outperform.

On the other hand, real investors like Marty Whitman at Third Avenue, or the guys at Dodge & Cox don't make you comfortable. They make you rich.

Many of the stock ideas I had back in my suit-and-tie days ran counter to what my brokerage preached. I was terrible at selling the stock of the day, or the proprietary products such as in-house mutual funds and unit trusts. Instead, I preferred to turn over rocks looking for cheap stocks, or, when interest rates were distressingly high and bond prices proportionately cheap, I would find myself, lonely, recommending zero coupon bonds. *Sound Advice* fits me best. If you're a subscriber, I presume it does you too.

--Gray Emerson Cardiff

## Bargain Bin Specials

The market has been wobbly for the last couple of months, which offers opportunities. In this issue, rather than recommending a new idea, we propose looking at the existing portfolio to find not just bargains, but bargains in blue chips, the sorts of shares you can buy and tuck away. Two are in the mega-cap category, and one is merely large cap. Each of these companies is below its high hit earlier this year, and since nothing material has changed about them, not to consider them now would be irresponsible. We admit that merely because prices have fallen doesn't mean they can't fall further still. Should that happen, unless something fundamental had changed for the worse, we'd be even more enthusiastic buyers. With that in mind, here are three stocks we think worth consideration now:

### ENCANA

The story for **EnCana (ECA—NYSE)** to an extent is the story for all other commodities. ECA had gone from \$59.82, an all-time high, in the aftermath of Katrina/Rita to \$41.47 in February when natural resource stocks tumbled. After rising to \$53.26 in May, shares again dropped sharply to the mid-\$40s two weeks later. After another rally in natural resource stocks that started in mid-June, ECA is back at \$52.02. Over the same period, natural gas spot prices have fallen from just over \$16 per MBTU in December 2005 to under \$5.18 today (-68%). If natural resource company shares are simply priced in tandem with the spot price for whatever they produce, the 31% drop for ECA from its February high to its low (-31%), less than half of the drop in natural gas prices, might be interpreted as a warning that natural gas company prices have much further to fall. But that simpleminded linkage, we think, is false.

The spot market tells you what is happening at the moment. The futures market tells you what could happen in the future, and it proposes that in the teeth of the 2006-2007 winter natural gas will move

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## Bargain Bin Specials

above \$10 per MBTU. Investors should pay more attention to the futures—but being human, investors respond to the now.

In February and again in May when ECA swooned, declarations from energy bears were abundant that the end of high energy prices was at hand. We think not. We think the case for natural gas prices rising as we approach winter are compelling. We also think that EnCana is beautifully situated to benefit. Our argument rests on the premise that demand for energy will remain robust, and the fact that the fall in natural gas prices during 2006 reflected not a trend toward cheap energy but a freakishly warm winter that blunted demand for heating.

As we write, the spot price on the NYMEX for crude oil stands at \$73.86 a barrel, close to the \$75.14, high hit on July 5th. Doubtless some of this run up in oil is due to global political instability, but there has been no significant decline in demand or in price. As for oil futures, they anticipate prices above \$70 till September 2009.

Second, how significant as a comparison are post-hurricane natural gas, oil, and gasoline prices? It is beyond debate that the post-hurricane season spike in energy was so extraordinary that we cannot rely on those prices, since the damage Katrina and Rita delivered to production platforms, undersea and land supply lines and refineries was what economists like to call an

exogenous event, that is something external to the normal model. In short, we ignore \$16 as a realistic price—at least for now—for natural gas.

Third, high energy prices last fall were also fueled by concerns with winter on the horizon that normal cold-weather demand would keep prices high. Indeed, had the 2005-2006 winter been normal the sharp fall never would have occurred, but this past winter was extraordinarily mild across most the United States. Thus demand was lower than anticipated, and we now have stored much more natural gas than expected. This unanticipated overhang in supply is now the single heaviest burden for natural gas prices. Compared to June 2005, the volume of stored natural gas is 19.2% higher. For that matter, oil storage is at an eight year high. All of which sounds more bearish for energy prices than reality suggests.

Let's start with the storage overhang. Total usable capacity provided by salt domes, aquifers, and depleted natural gas reservoirs amounts to about 4.1 trillion cubic feet. Currently 58% of that is filled with 2.4 trillion cubic feet. If this sounds like a lot, it isn't. Total consumption in the United States during 2005 hit 21.95 trillion cubic feet, which means that even at the current level we have on hand 11% of what we used last year. In short, any normal demand will quickly neutralize the overhang now in

storage. In fact, that overhang could begin to erode well before the winter heating season should hot summer weather push up demand for electricity.

At current prices natural gas once again is economically more attractive to use for generating electrical power than is oil, and is more competitive with coal. Currently, with oil over \$70 a barrel and natural gas well below \$6 per Million BTU, natural gas is about 45% less expensive in terms of BTUs. Coal, though cheaper per BTU than natural gas even at current prices, involves other use costs that diminish its competitiveness. Heavy consumers of energy, especially power generators, are able to switch between oil and natural gas depending on price. At the current differential, for those who can flip back and forth between the two, natural gas is a no-brainer.

Furthermore, just because storage levels are high doesn't mean that natural gas is in plentiful supply. To the contrary, finding natural gas lately has become much harder. Over the last year and a half, the rig count in North America drilling for natural gas has doubled without changing the level of production. In addition, even though the number of wells is up by 50%, production remains stagnant. In part, this is explained by the natural decline in production from any maturing well. It is also explained by the modest yield most new wells start at.

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## Bargain Bin Specials

Anadarko, a Houston-based energy company that concentrates on natural gas, validated how hard it is to find new reserves when last month it acquired Kerr-McGee and Western Gas for \$23.3 billion in cash. At times we've picked up rumors that EnCana itself might be a target for a large multinational such as **Royal Dutch**.

That is the macro argument. Let's briefly explain why EnCana is the way to play this. First, ECA has been able to increase reserves. Those reserves are also concentrated in stable regions. EnCana has diligently worked to reduce its exposure to regions vulnerable to political disruption (Ecuador) and natural disasters (Gulf of Mexico). These sales have generated \$3.3 billion that can be deployed to increase better situated reserves, and to pay down debt. The most dramatic increase in reserves could come from ECA's participation in Alberta's oil sands, where EnCana owns 1.2 million acres. Earnings also are on the rise, not surprising given the boom market in energy. The only drawbacks are rising labor and material costs, both evidence of inflation.

Our thesis remains that higher natural gas prices are ahead, and that investors will regain their affection for energy companies. Since we began writing this piece, ECA has started to move again. There's more to come, we think.

Finally, the dynamics for energy are not too different from the forces driving metals. Simply put, natural resource companies in the 1980s, 1990s, and during the first few years of this decade consciously reduced efforts to develop new wells and mines, because prices had been so weak for so long that executives were reluctant to commit the cash.

Now, with demand and prices sky high, these same companies are scrambling to catch up. It will take awhile. Buy up to \$58.

### **JOHNSON & JOHNSON**

**Johnson & Johnson (JNJ—NYSE)** has moved up 6% since inclusion in the portfolio in March, swimming against the general market tide which has taken the benchmarks down 1%. We think that at \$60 JNJ remains not only a bargain in fundamental terms but is also attractive thematically, since as the U.S. economy slows, investors will look to more defensive sectors such as healthcare and pharmaceuticals.

But JNJ is more than just a safe

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harbor. Johnson & Johnson offers prospects for significant revenue and earnings growth.

For the last few years, pharmaceutical companies have been neglected by investors amid concerns that generics were cutting into their profits, that few blockbuster drugs would boost sales significantly, that public anger at high drug prices posed a political threat, and that the future belonged to young biotech companies primed to create medical miracle drugs beyond the abilities of old line pharma companies such as J&J. Finally, JNJ's inability early this year to complete the acquisition

of Guidant, a medical device company, convinced some Wall Street analysts that Johnson & Johnson management did not have what it takes.

Let's start with the last point, since losing the bidding contest for Guidant to Boston Scientific marked the start of a price slide that took JNJ down 17%. Though adding Guidant to its formidable cardiovascular device business at the right price was its goal, when news broke that Guidant had to recall defective devices J&J trimmed its bid. J&J then stepped aside when BSX pushed its own bid to a level JNJ could not justify. Rather than revealing management to be duds, the decision to let Guidant go, in our mind at least, confirms Johnson & Johnson management's worth. Last month's news that Guidant was again recalling more than 27,000 defibrillators dropped BSX shares to a multi-year low, which only made JNJ management look all the better. For JNJ, paying too much for an acquisition just because they could was no virtue. Expect to see JNJ find another candidate to expand its medical device business.

Medical devices admittedly are lucrative. However, JNJ is strong on so many fronts that in our recommendation we characterized it as little different from a mutual fund for healthcare—except unlike Vanguard Healthcare Fund, its assets remain undervalued, since they are not marked to market. In addition to medical devices and diagnostics (38% of 2005 sales) and pharmaceuticals (44%), Johnson & Johnson is dominant in consumer products (18%), which include non-prescription drugs, personal care, infant and baby products, and oral care items. With 230 separate

## Bargain Bin Specials

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companies operating under the JNJ banner, we have the most diversified healthcare products company in the world. Finally, unlike some companies, JNJ is not vulnerable to the ups and downs of any one product. No single product accounts for more than 10% of JNJ's revenues.

As we were writing this, Johnson & Johnson announced a major acquisition. For \$16 billion, JNJ is acquiring Pfizer's consumer products division, which will add brands like Sudafed, Visine, Neosporin, Listerine, and Nicorette. J&J's consumer division accounted for \$9.1 billion in sales last year. The Pfizer unit should add another \$4 billion, and will increase the consumer products division at JNJ to 25% of total sales, though margins for consumer products are lower than for either medical devices or prescription drugs.

As for drug lines, even if JNJ has no blockbusters coming soon, the company does have more than a dozen new drug applications in the FDA pipeline, which should keep sales growing. Furthermore, its research, especially in biotech, is rich and productive. *Morningstar* makes the telling observation that were JNJ's biotech companies treated as a separate entity, they would constitute the second largest biotech company in the world, second only to Amgen in terms of sales.

We also can't resist pointing out that 44% of JNJ's sales are outside the U.S., and if we are right about the downward slide for the Greenback, then we can expect a boost from currency conversions. Buy up to \$65.

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### **AMERICAN INTERNATIONAL GROUP**

**American International Group (AIG—NYSE)** brings together several elements that are catnip for us. First, it is the pick of the litter among insurance companies yet is trading at blah valuations. Second, 16 months after booting its iconic CEO, Maurice (Hank) Greenberg, AIG remains under a cloud as investors try to gauge how AIG will fare without Greenberg, who is both credited for making AIG the juggernaut it is and blamed for damaging the company through self-dealing. Third, it has a lock on insurance sales in Asia, especially in China, which should boost earnings in years to come. Lastly, AIG, though it derives 63% of its sales from insurance businesses, is also a services company involved in financial services (24% of sales), asset management (13%), and other financing activities. It also towers over its competitors with a market cap of \$153 billion. For comparison sake, the next largest property and casualty insurer, Germany's Allianz Group is \$58 billion.

AIG had moved crisply from our original recommendation just under \$52 in April 2005 to \$71 this January, and subsequently has fallen back to just under \$59. The original bounce up represented a classic drop in pessimism created by the Greenberg dismissal and by related accounting issues in 2004. The more recent price fall, we believe, was also a classic short-term/short-sighted response to weaker than expected results reported for the first and second quarters of 2006, which Wall Street in its wisdom extrapolated beyond the horizon.

First off, the disruptive turmoil surrounding Greenberg is over. AIG has settled with regulators, has adjusted its SEC filings, taken write-downs to its balance sheet, and replaced Greenberg and his lieutenants. Second, AIG is not just huge, it is diversified widely both globally and in terms of products. The earnings disappointments are real, though compounded by write-offs related both to Greenberg's doings and to changes new senior management have ordered. These are one-time events, and we expect to see AIG earn in the mid-\$5s this year, and \$6 next year. If we apply the average P/E at which AIG has traded in the past, we aim at a \$90 target. Other standard valuations point to a similar price target.

As value investors, we are content to own companies that might not be dynamic but are priced so cheaply that merely returning to stodgy historical valuations can generate a nice profit. In AIG's case, not only are shares trading below what we consider fair value but the potential for growth in revenues, cash flow and earnings is significant.

It's the "International" in American International that holds out the biggest potential, since for decades AIG, which got its start selling insurance in China during the 1920s, has been busy establishing insurance businesses in 130 countries around the world. Japan, a mature economy, is very profitable, and in emerging economies, particularly in China, sales are growing even faster. AIG is the only foreign company approved by Beijing to operate independently, a huge advantage over others who might consider entering this untapped market.

As with JNJ, we have the chance to accumulate blue chip shares at a blah chip price. Buy up to \$66.**SA**

## PORTFOLIO UPDATES

The market ever since early May has been troublesome, volatile in both directions with a downward trend. Since the June letter, the usual benchmarks are down on average 2.4% while *Sound Advice* is off 2.2%. For the year the Dow is up 3.5%, the S&P 1.4%, and the Nasdaq down 3.4%, which averages out to a piddling 0.4%. We're up 7.3%.

**Wal-Mart**, the June recommendation fell 3.8%, the result primarily of management's announcement at the end of June that the month's same store sales (stores open for at least one year) were at the low end of projections, up 1.2%. WMT earlier had advised analysts that it expected growth between 1% and 3%. In 2005, growth had been 4.2%, a stiff basis for comparison. Explanations for the shortfall were numerous, but the most convincing for us is that higher gasoline prices were hurting WMT's core customers, low to middle income households. Were there no problems at Wal-Mart, we could not be picking up shares at these prices, and despite the pain high gas prices inflict, a slowing economy is fine for WMT to shine.

Indeed, the slowing economy theme might explain why some stocks did better than others. Our best performers were **Molson Coors** (4.1%), **Safeway** (4.1%), **AT&T** (3.8%), **Coca Cola Enterprises** (3.1%), **Crescent** (2.8%), **Royal Dutch** (2.2%), **HRPT Properties Trust** (2.2%), and **Friedman, Billings and Ramsey** (1.9%)—nary a growth stock among them. One thing they have in common, each pays a dividend, though that can't be the reason in all cases. Yes, these three REITs pay between 7% and 8%, and two (AT&T and RDS.A) pay more than double the average

yield for the S&P 500, but the others are either average (TAP) or piddling (CCE at 1.2% and SWY at 0.9%). CCE, SWY, and TAP are decidedly defensive businesses, which are only minimally dinged in a slowing economy, Shares of grocers, soft drink makers and beer brewers,

even though the beverages aren't as essential as other staples bought at the grocer, are inexpensive. Royal Dutch is interesting, since along with its peers in the major multinational group it has been running higher than not just the weak S&P 500 but higher than other energy sectors that had run circles around them during most of the energy bull market. The only explanation that seems plausible is that the market might at last be giving these companies their delayed due, because finally the idea is setting in that robust energy prices are here to stay, and even if the rate at which earnings will rise in the future cannot match the distance they already have covered, the sustained price of oil and (eventually) natural gas justifies paying more for the energy giants' earnings.

**Friedman, Billings, Ramsey** has been moving for several weeks, and now we have an explanation: FBR, which includes within its mortgage REIT structure a robust brokerage and banking business, is reorganizing, and selling a portion to a private equity firm.

One more comment about REITs. We disagreed with the widely held

opinion that with rising rates REITs would tumble. As it happens, equity REITs are up almost 10% for the year, and are doing far better than the benchmark equity indexes. Against bonds, the advantage is more striking still. For example, the Vanguard Long Term Treasury

### Password for Online Updates and Next Issue

The NEW PASSWORD for Updates to be published at the start of August will be **leisure**. To access the August issue when posted online (Monday, August 14th) **the same password, leisure, should be used.** If you are not enrolled to receive this free access, please send us an email at [sound\\_advice\\_ca@yahoo.com](mailto:sound_advice_ca@yahoo.com) with your name, zip code and email address.

Bond Fund is down 5.2%. *SNL Real Estate Securities Daily* continues to chronicle consummated acquisitions both by publicly traded and private buyers as well as rumor of more to come as one reason for REIT strength. Furthermore, there is more optimism than pessimism about REITs' ability to keep rents healthy.

The worst performers included **Coeur d'Alene** (-8%), **Liberty Global** (-7.8%), **Phelps Dodge** (-7.7%), **Sara Lee** (-7.2%), **Agrium** (-6.5%), and **Sony** (-6.1%). Precious metals have been knocked around by concerns over rising interest rates. The dynamic for metals, especially precious metals, is that rising interest rates have two negative effects. First, rising rates siphon off cash that might be invested in precious metals, which also supports the dollar. Second, but more importantly, higher rates make leveraged (financed) investments less profitable and more risky. Coeur d'Alene investors also have to contend with concerns over exposure to the whims of the Bolivian government, which lately has nationalized assets of foreign energy companies. We still believe that precious metals

## Sound Advice: Portfolio Updates for July 2006

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will be profitable as the dollar declines and concerns about inflation here and abroad bring in buyers. **American Century Global Gold Fund** is down a scant 0.9%.

**Liberty Global** dropped after a self-tender offer for its common shares ended on June 26<sup>th</sup>.

As for the other Liberty spinoffs in the portfolio, we are selling **Liberty Interactive**, one of two tracking stocks spun off last month from **Liberty Media**. We retain **Liberty Capital**, which holds passive positions in several publicly traded companies, the most prominent being **TWX** and **News Corp.**

We continue to like the cable industry here at home (**Comcast**) and particularly abroad, since benefits from consolidation are still to be realized, and with John Malone, who made fortunes for himself and his shareholders here in the U.S. with TCI, overseeing the operation, we look forward to solid profits.

**Sara Lee** has disappointed us. Sara Lee as it prepares to spin off its non-food businesses is getting zero respect for any of its restructuring moves, which is maddening since the company owns assets we think are worth significantly more than Wall Street says. Last quarter's mediocre results have undercut faith in management's ability to deliver on its plans. At this point, the generous dividend seems unlikely to last, though when **ConAgra** cut its distribution last March, CAG share price reversed field, and is up 10% for the year.

It's been a hard couple of months for natural resource stocks, but we recommended in the June issue that the best course was to hold on, since we viewed the decline in prices for commodities as only a retreat in a longer climb. As Will Rogers during the 1930s observed about real

estate's growing scarcity and thus increasing worth, they aren't making any more of the stuff, we can say the same about natural resources.

Gold and silver prices rebounded too with **American Century Global Gold Fund** jumping 22% and **Coeur d'Alene** up 19% since metals bottomed in mid-June. The key to the resurgence seems clear: inflation and the prospect that at least in the U.S. the Fed is thinking about pausing its clockwork increases in interest rates. If this explanation seems contradictory (inflation and a pause in interest rates coexisting), think about the obvious driver, inflation, as persistent and ultimately decisive, but also think about speculators' preference for lower carrying costs. The Fed's hoped-for decision would mean it would be cheaper to speculate on the prospects for higher metals prices and on inflation.

**Phelps Dodge** dropped sharply (-9.8%) on Monday, June 26<sup>th</sup>, when it announced it would acquire for about \$40 billion two large Canadian nickel miners, Inco and Falconbridge, which Inco itself was in the process of trying to acquire. The immediate drop in PD shares was normal arbitrage. The drill is simultaneously to buy shares of the acquisition target and to short shares of the acquirer. Hence, the massive selling of shares in PD. Phelps Dodge's initiative, should it be completed, would move it from being primarily a copper company to not only the world's largest nickel miner but also one of the biggest diversified mining companies on a par with Australia's BHP Billiton and Britain's Anglo American. PD has recovered most of its post-announcement slide (3% off the pre-announcement price), which has

triggered speculation that either the deal might not go through or that PD itself might be on someone's shopping list.

Phelps' move (and attempts by others to acquire Falconbridge and Inco that it squelches) signals that miners are facing the same pressures we are now seeing in the energy patch: it is more efficient to expand reserves on Wall Street than out in the world, because not only are new, large and cheap to lodes getting harder to find but they are often in risky neighborhoods. Nickel and copper remain in short supply, and Phelps Dodge decision to add nickel to its portfolio is a positive sign for future metals prices.

**Perrigo**, one of the few stocks that advanced during the May-June slide, announced a couple of solid products: a generic version of Nicorette, the smoking-cessation gum, and earlier in the month partnered with an Israeli drug company to market and distribute an over-the-counter version of Prilosec, the anti-heartburn drug.

We are pleased to see Perrigo using its excellent relationships with large retailers to make money from products developed outside its own labs. Since the last letter, PRGO is off 5.1%. We believe that makes no sense. Johnson & Johnson's announcement that it was buying Pfizer's consumer division for \$16.6 billion should inject more interest in Perrigo, which competes against national brand OTC drug companies like J&J. If J&J, no fool when it comes to making disciplined acquisition bids, thinks that the Pfizer division is worth about four times sales, then Perrigo, which admittedly prospers on thinner margins, should be worth significantly more than the 1.13 times sales it currently trades at. **SA**

# Sound Advice: Portfolio for July 2006

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$11.64	7.22%	\$12.00	BUY
Senior Housing Properties	SNH	NYSE	\$18.02	6.88%	\$20.00	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$23.06	0.48%	\$29.00	BUY
American International	AIG	NYSE	\$58.97	0.85%	<b>\$66.00</b>	BUY
AT&T	T	NYSE	\$27.74	4.51%	\$30.00	BUY
Coca-Cola Enterprises	CCE	NYSE	\$20.39	0.78%	\$24.00	BUY
ConAgra	CAG	NYSE	\$21.86	5.00%	\$26.00	BUY
CSX Corporation	CSX	NYSE	\$67.33	0.59%	\$77.00	BUY
Disney	DIS	NYSE	\$29.83	0.80%	\$34.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$39.02	0.36%	N/A	BUY
Excelsior Value & Restructuring	UMBIX	800-446-1012	\$47.97	0.70%	N/A	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	\$17.03	0.00%	N/A	BUY
Friedman, Billings, Ramsey	FBR	NYSE	\$10.85	7.37%	\$12.50	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$18.38	0.00%	N/A	BUY
Honeywell	HON	NYSE	\$38.96	1.93%	\$45.00	BUY
Johnson & Johnson	JNJ	NYSE	\$60.62	2.18%	<b>\$65.00</b>	BUY
Liberty Capital***	LCAPA	NASDAQ	\$84.40	0.00%	\$87.00	BUY
Liberty Interactive Media***	LINTA	NASDAQ	\$17.23	0.00%	N/A	<b>SELL</b>
Mattel	MAT	NYSE	\$16.56	2.42%	\$18.00	BUY
McDonald's	MCD	NYSE	\$33.18	0.69%	\$38.00	BUY
Molson Coors Brewing	TAP	NYSE	\$68.97	1.19%	\$72.00	BUY
Newell Rubbermaid	NWL	NYSE	\$25.46	2.59%	\$31.00	BUY
New York Times Co.	NYT	NYSE	\$24.34	2.71%	\$29.00	BUY
Perrigo	PRGO	NASDAQ	\$15.99	0.63%	\$18.00	BUY
Safeway	SWY	NYSE	\$25.21	0.00%	\$27.00	BUY
Sara Lee	SLE	NYSE	\$16.15	4.66%	<b>\$20.00</b>	BUY
Schering-Plough	SGP	NYSE	\$19.11	1.05%	\$24.00	BUY
Sony	SNE	NYSE	\$43.23	0.53%	\$54.00	BUY
Superior Industries	SUP	NYSE	\$17.87	3.58%	\$23.00	BUY
Tetra Tech	TTEK	NASDAQ	\$17.16	0.00%	\$20.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$57.46	2.58%	N/A	BUY
United Parcel	UPS	NYSE	\$81.09	1.04%	\$86.00	BUY
Wal-Mart Stores	WMT	NYSE	\$46.00	1.46%	\$52.00	BUY
Xerox	XRX	NYSE	\$14.12	0.00%	\$18.00	BUY
<b>Energy/Natural Resources</b>						
American Cent. Gold Fund	BGEIX	800-826-8323	\$18.92	0.00%	N/A	BUY
Coeur d'Alene	CDE	NYSE	\$4.70	0.00%	\$7.90	BUY
EnCana	ECA	NYSE/TSE	\$52.02	1.15%	<b>\$58.00</b>	BUY
Icon Energy Fund	ICENX	800-764-0442	\$35.55	0.00%	N/A	BUY
Phelps Dodge	PD	NYSE	\$80.24	1.25%	\$95.00	BUY
Plum Creek Timber	PCL	NYSE	\$35.49	4.06%	\$41.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	\$68.00	1.96%	\$70.00	BUY
Transocean	RIG	NYSE	\$78.24	0.00%	\$89.00	BUY
<b>Aggressive Growth</b>						
Comcast	CMCSA	NASDAQ	\$32.16	0.00%	\$38.00	BUY
Crescent Real Estate	CEI	NYSE	\$18.92	7.93%	\$22.00	BUY
Discovery Holdings	DISCA	Nasdaq	\$14.27	0.00%	\$17.00	BUY
Electronic Data Systems	EDS	NYSE	\$23.81	0.84%	\$30.00	BUY
Liberty Global	LBTYA	NASDAQ	\$21.51	0.00%	\$26.00	BUY
Mitsubishi UFJ Financial	MTU	NYSE	\$13.50	0.70%	\$18.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$5.97	5.53%	N/A	BUY
Time Warner	TWX	NYSE	\$16.84	0.00%	\$22.00	BUY
Syantec	SYMC	NASDAQ	\$15.14	0.00%	<b>\$18.00</b>	BUY
Western Digital	WDC	NYSE	\$19.70	0.00%	\$24.00	BUY

\*Prices as of the market close on Friday, July 7, 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 July 2006

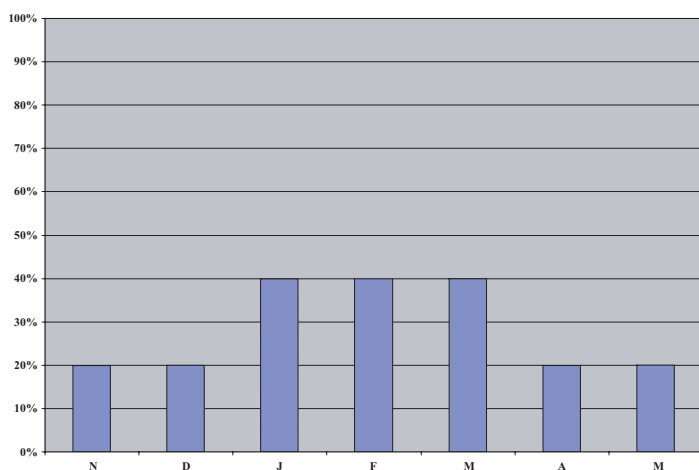
*Sound Advice* depends on three trustworthy indicators to determine our investment direction. The **Risk Indicator** (see inside front cover) measures investors' interest in real estate compared to stocks. Currently we see that the stock market is significantly overvalued versus real estate. The **Leading** 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	

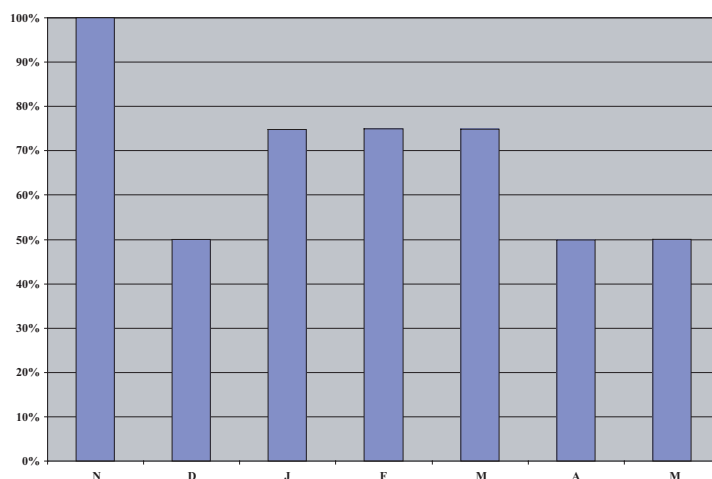
For years prior to 1992, the return percentages are calculated by purchasing the Twentieth Century Growth Fund on buy signals and investing in money market funds on sell signals. Following January 1992, the calculated returns assume funds were switched to the Sound Advice Model Portfolio. Signal Performance: 6.04 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 50%, 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 MAILS ON AUGUST 11TH**

precious metals will surge again.

Natural resource stocks, despite the disproportionate impact they have had on our performance, are only part of our portfolio. The rest, we are happy to say, are a hodge-podge of opportunistic positions acquired as the market put individual companies or sectors on sale. Would it surprise you to know that our two best performing recommendations in 2006 have been a truck maker (**Stewart & Stevenson** +65% this year), and an apparel maker (**Russell** +37%)? Other positions fall into defensive areas, and should outperform the overall market provided our expectations for inflation are borne out. Hence, healthcare, foods, consumer non-durables, basic apparel—all are built for leaner economic times here in the U.S.

As for international exposure, we are concentrated in

Japan. The Nikkei already had stalled out in early April at 17,563, falling as low as 14,208 two months later (-19%), and now is at 15,307, still a 12.8% drop. **Dodge & Cox International Stock Fund** is overweighted Japan, and remains 12.1% to the good for the year, while **Sony** is 9.3% higher. **Mitsubishi UTF Financial** is up 4.5%. **Fidelity Japan Fund** has lost 3.9% for 2006. We are willing to ride out what we believe is a correction in Japan. REITs, though we sold some off as prices went beyond reasonable, continue to outperform.

As we explain in our Bargain Bin article, there are bargains to be had now. If you invest for the long-term, there is money to be made. Also, if you see a brightly colored sticker on this issue warning that your subscription is about to expire, take a moment to resubscribe using the generous offers below.

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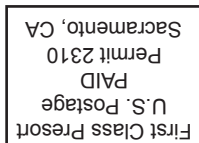


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