

Optimal Control



With our Diffusion Index of Lagging Indicators at 100 percent (see page 11), we are operating with caution. That means we are being much more selective until we have the green light from our Diffusion Index of Leading Indicators. We have positioned the *Sound Advice* portfolio for an improving economy and rising inflation.

Our focus on energy should bring attractive profits because energy is in the fabric of the economy.

Our “No-Brainer” ETFs have been languishing this year, but are poised for very substantial moves when long-term Treasury yields increase.

Our REITs and real estate stocks and funds should also benefit. Although interest rates will be pushing up mortgage rates, the corresponding increases in rental rates will more than compensate. These, along with our other hard-asset stocks and funds, should also benefit from the rising inflation that accompanies an improving economy.

Value stocks have been among the better performers at this stage in past cycles, when an improving economy is pushing up earnings, price/earnings ratios are shrinking, and interest rates are rising. Our value-oriented approach should continue to pay off.

-Gray Emerson Cardiff

You may have heard Janet Yellen refer to “Optimal Control” in several of her speeches. These are key words that give context to her attitudes and direction as the Chair of the Federal Reserve. These key words describe a certain mathematical theory that is influencing decisions at the Federal Reserve. It is important to understand because the Federal Reserve actions impact all of our investments.

The concept is not a creation of Ms. Yellen’s, nor is it new. The father of “Optimal Control Theory” is Lev Semenovich Pontryagin, who was born in Moscow in 1908. After being blinded at 14 from the explosion of his family’s paraffin stove, he became one of the greatest mathematicians of the 20th century.

Basically, the Optimal Control Theory is the use of a set of mathematical rules aimed at controlling and optimizing the result of a given process. A simple example would be to devise a set of rules to drive an automobile in order to achieve the most efficient fuel consumption. Later improvements and variations of the Optimal Control Theory are used in many science and engineering applications. One of the more notable was in landing the Apollo Lunar Module.

The Optimal Control Theory is not new to economics either. In this application, it is aimed at optimizing the economic outcome, as measured by unemployment and inflation, through the manipulation and control of short-term interest rates (the Federal funds rate).

Yellen embraces the Optimal Control approach as a scientific manner of determining monetary policy. In a 2012 speech, she said “...monetary policy aims to minimize the deviations of inflation from 2 percent and the deviations of the unemployment rate from 6 percent, with equal weight on both objectives.” At the time of that speech, putting the current numbers into the model suggested the Fed should hold rates near zero until early 2016. She showed a graph of what the economy might look like under optimal control, illustrating that if the Fed would keep the funds rate low longer, unemployment would fall faster. Inflation would rise slightly above the Fed’s target, but only for a few years. Overall, that’s much better than the current outlook.

Now, the latest reading of inflation is 2.1 percent, and unemployment is 6.2 percent. Both are now close to the Federal Reserve’s targets.

So What’s Next?

Yellen owes part of her dovish reputation to her embrace of the Optimal Control policy which tolerates inflation rising above the Federal Reserve’s 2 percent goal in exchange for a more rapid decline in unemployment. In her various testimonies and speeches, Yellen has said that the Fed could achieve a faster reduction in U.S. unemployment at the modest price of a bit more temporary inflation than it would get if it set policy with rigid respect for

its percent inflation goal.

Yellen has also compared the Optimal Control policy to the Taylor Rule. (The Taylor Rule shows that the Federal Funds rate should be at least 1.25 percent rather than zero. See the June 2 issue of *Sound Advice* for more on the Taylor Rule.) She acknowledges that the Taylor Rule is more straightforward, but it has its own drawback - After periods of extreme weakness like the past few years, it calls for rates to rise too much, too soon.

From her subsequent testimonies and speeches, it is clear that Yellen is very concerned about the unemployed, more so than inflation. Even in the formal statement after the two-day meeting in late July, the Fed acknowledged the recent rapid fall in unemployment but it added "A range of labor market indicators suggests that there remains significant under utilization of labor resources."

The focus on unemployment means Yellen will push for keeping the Federal Funds rate relatively low for the benefit of the unemployed. With continued signs of economic strength, we may see the Federal Funds rate rise modestly above the current rate of zero, but still stay relatively low. This policy will continue to fuel economic growth. However, concern over rising inflation will be secondary, and this is what we need to keep in mind when making our investment choices.

The "No-Brainers"

The ETFs we are recommending, designed to benefit from rising long-term Treasury bond yields, differ in the amount of leverage used:

The [Direxion Daily 20 Plus Year Bear 3 Shares \(TMV\)](#) uses 3:1 leverage.

The [Proshares Ultrashort Lehman 20 Plus Year Treasury \(TBT\)](#) uses 2:1 leverage.

The [Proshares Short 20 Plus Year Treasury \(TBF\)](#) uses no leverage.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance.

We have dubbed these ETFs as "No-Brainers" because interest rates always rise after a recession during the recovery. The upward path has never been smooth, and this time is proving to be no exception. During the first quarter, the sluggish economy pulled down long-term bond yields sharply. However, during the last days of July, it was announced that GDP was at a robust 4 percent annualized rate.

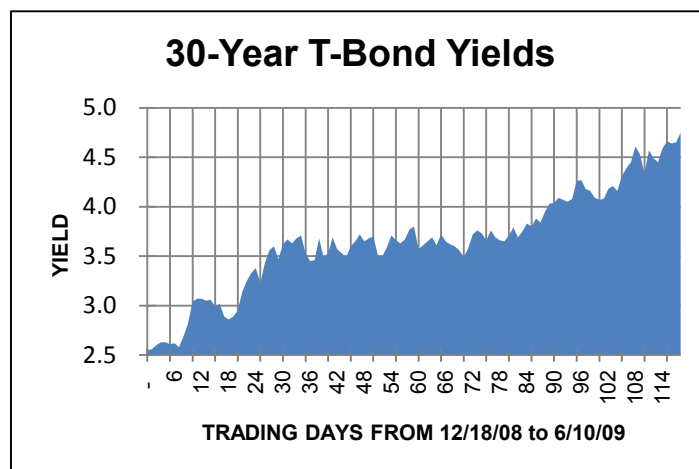
Our Diffusion Index of Lagging Economic Indicators (page 11) hit 100 percent for the fourth time in a row in June (the latest data available) which tells us that the economy is now strong enough to push up inflation and long-term interest rates along with bond yields.

We also know that long-term Treasury bond investors normally require a real rate of return of 3 percentage points above the rate of inflation. That means the 30-year Treasury bond should be yielding close to 5.0 percent right now.

It is hard to imagine that 30-year bond yields will remain at current levels much longer. Even though the Federal Reserve is likely to keep short-term interest rates relatively low, they do not control the long-term end of the bond market, which has a mind of its own. Recall that it was barely one year ago when Bernanke's mention of starting to taper bond purchases sent long term Treasury bond yields up 50 basis points during which time the Federal Reserve was still buying the full amount of Treasuries and the Federal Funds rate was zero.

The No-Brainer Model

The most recent time long-term Treasury bond yields rose significantly was from December 18, 2008 to June 10, 2009, (118 trading days) when we had a mild and short-lived recovery. Yields on 30-year Treasury bonds rose from 2.55 percent to 4.75 percent, or 220 basis points. The chart below shows the pattern.



Our No-Brainer ETFs did not exist during this entire period, so we don't have historical track records to view. However, we know how these ETFs work, and can model them to get an idea of the profit potential.

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The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds with an average maturity length of close to 27 years. The prices of our No-Brainer ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

To construct our models, we start with a projection of an increase in 30-year Treasury bond yields. A conservative approach would be to assume that long-term Treasury bond yields will not rise beyond 4.75 percent -- not any higher than the last peak. We can use the pattern of the last 96 days of the 220 basis point rise when yields rose from today's yield of 3.30 percent to the peak of 4.75 percent. In that scenario, our No-Brainers would rise to the following levels:

TMV would climb to \$82, for a 79 percent gain. The graph to the right shows the pattern.

TBT would climb to \$89, for a 51 percent gain. The graph to the right shows the pattern.

TBF would climb to \$35.25, for a 24 percent gain. The graph to the right shows the pattern.

While the pattern of today's rise is unlikely to be exactly the same as the previous rise, a 4.75 percent yield serves as a reasonable target. After yields rose to 4.75 percent on the last rise, the economy was considerably weaker than it is today and subsequently went into a decline.

We continue to note that a target of 4.75 percent does not require a full recovery to the inflationary stage of the business cycle. Our objective is only for Treasury bond yields to recover to normal levels, to the vicinity of 4.75 percent, from the artificially low yields caused by the 2008-09 economic meltdown and the subsequent massive bond purchases under the Federal Reserve's unprecedented Quantitative Easing programs.

The Erosion Factor Risk

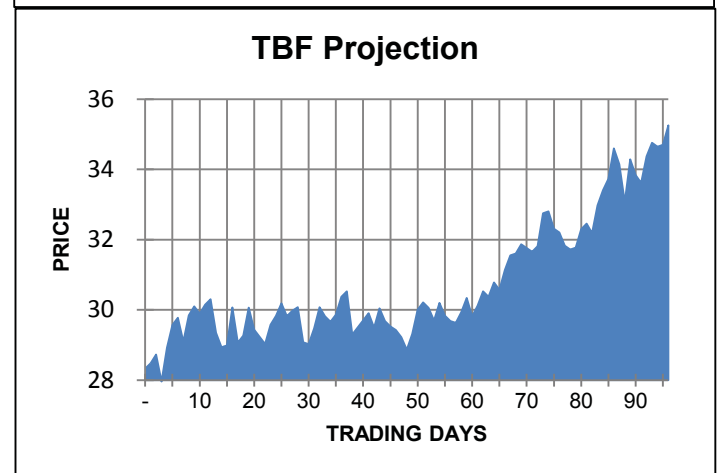
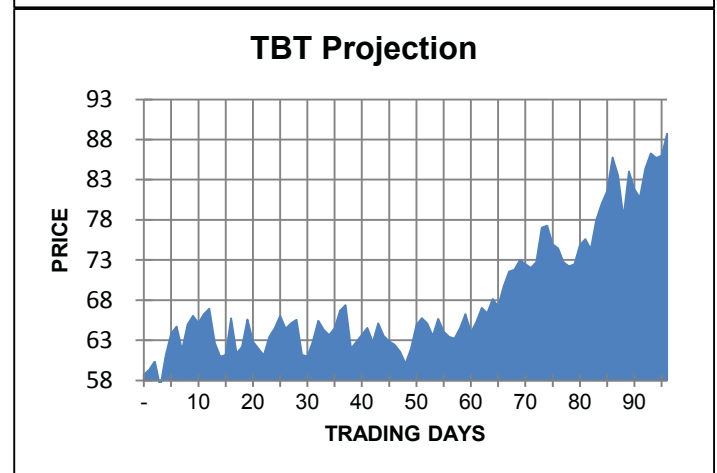
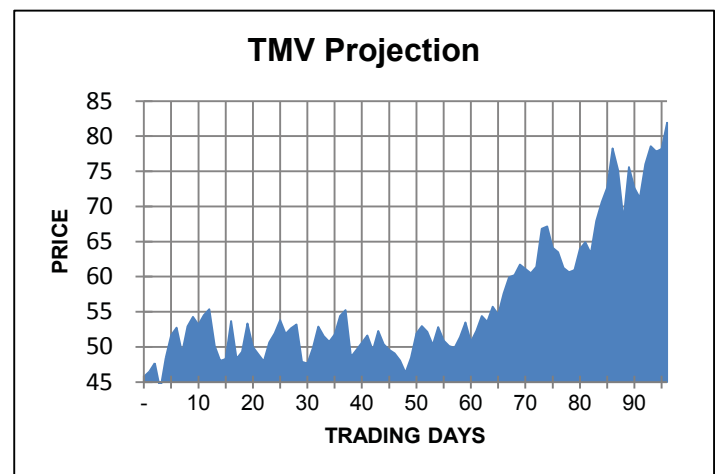
It is worth mentioning again that there is an "erosion factor" with these ETFs, and it is more pronounced with leverage. To illustrate, let's say long-term Treasury bond yields simply vacillate and go nowhere for a while. To take a somewhat extreme example, let's say yields go up and down by 5 basis points, from 3.30 to 3.35 one day, and back down to 3.30 the next. On the upswings TMV will advance by 2.62 percent. However, on the down swings, TMV will decline slightly more, by 2.64 percent.

If these daily fluctuations persisted through the end of the year, the price of TMV (with 3x leverage) would erode by 4.64 percent. TBT (with 2x leverage) would erode considerably less, by 2.31 percent. TBF (no leverage)

would erode hardly at all, by 0.75 percent.

If these daily fluctuations persisted for a full year, the price of TMV would erode by 8.45 percent, TBT would erode by 3.83 percent, and TBF would erode by 0.95 percent.

Daily fluctuations of 5 basis points does not happen often, and to assume such would persist for a long period is an extreme example. However, it illustrates why these are not intended to be long-term investments, especially those with higher leverage. In this example, the erosion factor of TBT is half of TMV's. Although the erosion factor is relatively small in comparison to the gains achieved by rising bond yields, it is a risk factor in making your choice of which ETF is most suitable for you.



Portfolio Updates

Here are updates on the rest of our recommendations in alphabetical order. The table on page 9 details our buy limits and other information on each recommendation, and organizes them by investment objective. Also see our website for live pricing.

Agrium (AGU) is essentially unchanged this year, leaving our profit at 693 percent.

So far, sanctions against Russia have not targeted Uralkali, Russia's giant fertilizer producer which competes against Agrium and other western fertilizer companies. However, continued escalation of sanctions may include Uralkali which would benefit AGU for two reasons: the most obvious is the limitation of competition. In addition, Uralkali recently pulled out of the Russian consortium so that it could undermine fertilizer markets with low prices in order to gain market share. Curtailing Uralkali would have a dual benefit.

Aside from the potential benefit from further sanctions, AGU has a broad mix of agricultural products and services that are poised to benefit from growing demand as arable land continues to disappear around the world and the need for higher food production per acre increases. Growth is also bolstered by an expanding worldwide population along with increasing per-capita income.

AGU has a solid dividend yield and is undervalued at 10 times the expected 2015 earnings of approximately \$9.00.

AMN Healthcare (AHS) is down 5.5 percent this year, trimming our profit to 162 percent. AMN Healthcare provides temporary healthcare staffing services to the healthcare industry, ranging from nurses to physicians. We recommended this stock at an average price of \$5.35 based on the rationale that it was a two-fer. AHS was not just an opportunity to invest in healthcare, which is traditionally a non-cyclical industry, but it was also a chance to buy into a healthcare business that would benefit from a recovery in the economy.

As our growth forecast was panning out, the stock advanced sharply in 2013. As its price/earnings (P/E) ratio expanded above 20, we recommended holding off on purchases. Since then, the stock price has been slipping.

AHS dropped back into our buy range below 12 in May, and has since advanced. We have since had AHS on hold. The price/earnings (P/E) ratio is lofty again, close to 20. A high P/E anticipates that high growth rates are immediately ahead, an assumption we believe could be dangerous. The Company's net income has been flat this year. This trend could continue under the vagaries of the Affordable Care Act which would be disappointing for AHS shareholders. **Accordingly, we think the risk/reward ratio is not favorable and recommend selling AHS.**

Associated Estates Realty Corp (AEC) is up 13.5

percent so far this year, extending our gain to 30 percent. What originally attracted us to AEC was the fact that it was selling at a substantial discount to the value of its net assets, and it paid a nice dividend. Although AEC has since risen in price, so has the value of its real estate portfolio. It remains a stellar value with a nice dividend of 4.2 percent.

At the end of July, AEC reported second quarter results of a 4.5 percent increase in the net operating income from the same apartment communities owned during the last year. Funds from operations were \$0.31 per common share, unchanged from a year ago. The average occupancy of all apartment properties was 96.4 percent, up slightly from 95.6 percent one year ago.

We value the equity of AEC's apartment portfolio at approximately \$28 per share, considerably greater than the current stock price.

Boston Scientific (BSX) is up 4.7 percent so far this year, extending our profit to 33 percent. BSX's medical products are well suited for an aging population in the US. The Company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs.

Chesapeake Energy (CHK) is up 6 percent this year, extending our gain to 77 percent. CHK is the second largest producer of natural gas and pioneered the use of fracking technology to produce oil liquids and natural gas from shale. We added CHK to the portfolio because it was at a substantial discount to its net assets. The stock price was cheap because of low natural gas prices, poor corporate governance, and because it was in the midst of a financial squeeze. We could see all of these conditions were likely to be remedied, and indeed they were.

You recently received one share of Seventy Seven Energy (SSE) for each 14 shares you held of CHK. At \$23.32 per share, the SSE shares equate to a value of \$1.66 per share of CHK. You can look at it like you received a special dividend of \$1.66 per share from CHK. Unlike a dividend, however, this spinoff lowers your cost basis of CHK. Cutting through a complicated analysis, the spinoff of SSE is good for CHK because CHK also spun off a lot of debt to SSE. That means the overall value of SSE is not as good as CHK. SSE is a small company loaded with debt and dependent on its parent (CHK) for 85 percent of its revenues. **We recommend you sell these shares.**

It is also interesting to note that Value Line's fair value estimate of CHK was reduced by \$1.00, to \$37 from \$38 primarily as a result of the SSE spinoff, not \$1.78 which is the value of the current SSE stock price. This is further confirmation of our view that SSE is over-valued and should be sold. It also confirms that CHK is still undervalued

because \$37 is still substantially higher than the current stock price.

In late July, CHK announced it will buy back all of its outstanding preferred shares for \$1.26 billion. From a common stockholder's point of view, this has the same impact as does the elimination of debt because preferred shares of senior in the liquidation sequence. This will simplify CHK's balance sheet and eliminate \$75 million in annual preferred dividends.

CommonWealth REIT (now Equity CommonWealth REIT – Ticker “EQC”) is up 17 percent this year, extending our gain to 30 percent. We originally introduced CommonWealth when it was selling for close to a 50 percent discount to its NAV. Subsequently, two large investors, Corvex and the Related Companies, woke up shareholders by sponsoring a proxy vote to remove the entire board and management.

Sam Zell is now chairman of the board and should be improving the management this REIT's assets. As an initial step, effective August 1, management changed its name to Equity Commonwealth, along with its ticker symbol to EQC.

Zell is also chairman of Equity Residential (EQR) and Equity LifeStyle Properties (ELS). Zell said, “This name change reflects a new chapter for the company, in keeping with the other ‘Equity’ companies, Equity Commonwealth will operate with an entrepreneurial culture, where the interests of all stakeholders are aligned, focusing on long-term value creation for Equity Commonwealth's shareholders.”

In July, Zell along with the new chief executive officer, David Helfand, hired Adam Markman, as the new chief financial officer. Markman was a managing director at REIT research firm Green Street Advisors Inc. The first move of this team was to sell its 22 million shares of Select Income REIT, the largest owner of industrial land in Hawaii, for \$705 million to two companies run by CommonWealth's ousted President and son, Barry and Adam Portnoy.

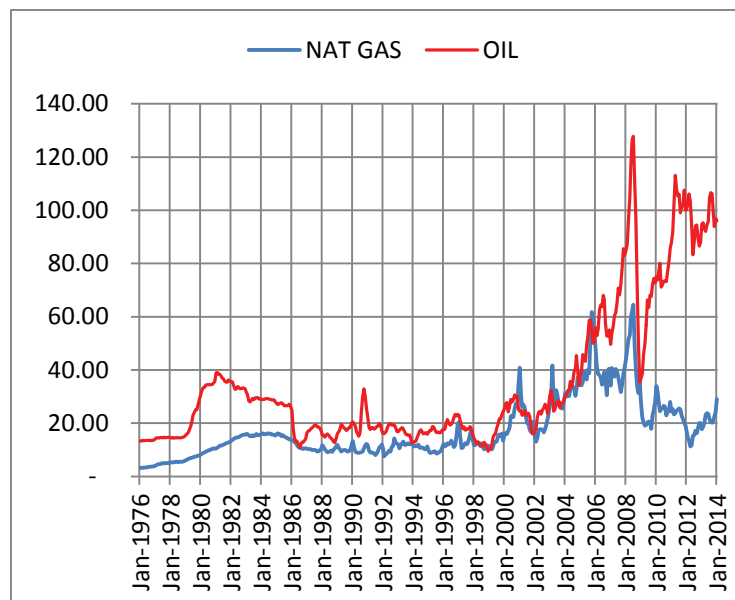
The dividends have been declared on the preferred shares, and management is evaluating its options regarding the appropriate policy regarding the dividend on the common shares.

Based on the latest financials, we currently value the stock at approximately \$32.50 per share, which is still substantially above the current stock price. As a confirmation of our valuation, Corvex/Related has contended the stock is worth more than \$40 per share with better management.

Fidelity Select Natural Gas Fund (FSNGX) is up 18 percent this year, extending our gain to 39 percent.

Natural gas prices spiked in the UK when sanctions were announced against Russia. However, North American gas

The Cost of Energy Equivalents of Oil and Natural Gas



prices had little reaction because the markets here are somewhat isolated. While North American producers are not likely to see much upside from the sanctions, there remains a large gap between the energy equivalents of oil and natural gas.

Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other sources of energy, which translates into an inexorably vibrant and expanding natural gas industry.

One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. With one barrel of oil at \$100, that is the cost of 5.8 million BTUs of energy. On the other hand, with a market price for natural gas at \$5.00 for one million BTUs, 5.8 million BTUs will cost \$29 (5.8x\$5). So the same amount of energy is available for 29 cents on the dollar -- if it is in the form of natural gas.

To illustrate the point, we continue to display the historic relationship between the costs of these two forms of energy in the chart above because it demonstrates that today's disparity is not a normal situation.

The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Note that for most of the time (36 years), the two forms of energy are closely aligned.

Freeport-McMoRan Copper & Gold (FCX) was originally added to the portfolio last year at \$30.42 per share. FCX is up 22.6 percent since we recommended it.

Copper is woven into the fabric of every developed

economy, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. In March 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. As the world's economies continued to expand into 2008, so did FCX.

Since the Phelps Dodge transaction, FCX has added substantially to its copper reserves and continues to have opportunities to add reserves because of its large resource base and ongoing exploration program.

The 2013 acquisition of substantial oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico is an added bonus both for earnings growth and stability. Growth in earnings is ahead and the dividend yield is attractive, plus it reduces risk.

FCX delivered a strong operating performance in the second quarter. The results were despite reduced output from its Grasberg mine, one of the largest copper and gold mines in the world. However, in late July, Freeport entered into a memorandum of understanding with the Government of Indonesia to increase royalties to 4.0 percent from 3.5 percent for copper and to 3.5 percent from 1.0 percent for gold. Freeport may now resume full operations which will lower production costs, increase export volume, and thus add to earnings beginning in August.

Meanwhile, Freeport commenced copper production at its newly expanded Morenci operation. It also continued progress in its mining operations as well as in its oil and gas development projects.

Hambrecht & Quist Life Sciences Fund (HQL) is up 6.2 percent this year, extending our profit to 54 percent.

We have been recommending this Fund because the most explosive profits in the entire healthcare industry can be found in biotech companies.

In 2013, the worldwide sales of six of the top ten drugs came from biotechnology origin, and 75% of companies in the NASDAQ Biotech Index (NBI) had revenues of \$10M or more as compared to virtually zero revenues to ten years ago. The consensus of analysts is that earnings growth in the biotech sector will exceed that of nearly all other sectors of the economy.

HQL's significant holdings include Gilead Sciences, the inventor of *Sovaldi*, a drug that cures Hepatitis C, which promises to be the most successful drug ever.

Recent FDA approved significant drugs among HQL's holdings include Celgene's *Otezla* for psoriatic arthritis, Biomarin Pharmaceutical's *Vimizum* for Marqui A syndrome, and Pharmacyclic's *Imbruvica* for chronic lymphocytic leukemia.

Encouraging clinical data for other holdings include Biogen Idec's *Isis-smnrx* for spinal muscular atrophy, Medivation's *Xtandi* in pre-chemotherapy prostate cancer, and Gilead's PI3K drug *Idelalisib* in both lymphoma and leukemia, along with Amgen's and Regeneron Pharmaceutical's antibodies for cholesterol, Puma Biotechnology's *Neratinib* for breast cancer, and Sangamo BioSciences' use of its technology to effect a relatively durable "cure" of HIV.

Hersha Hospitality (HT) is up 19 percent since our recommendation in December 2013. Our principle reasons for recommending HT were because hotel assets in general are sensitive to the business cycle and will benefit strongly from the economic recovery.

In addition, the price of the stock is depressed and selling at a discount to its net asset value because many of its major properties have been undergoing renovations, and the income potential has not yet been realized.

Second quarter results will be reported in August. Based on the most recent first quarter financials, we value HT's NAV at \$7.33 per share, which is substantially higher than the current price of the stock. We expect to see further increases of NAV as income from new acquisitions are realized along with increased income from completed renovations.

HT has an excellent risk/reward ratio. Risk is minimized with the stock below a currently depressed net asset value. The dividend is solid because it is well-covered by funds from operations (FFO). The yield is attractive and limits downside movement in the stock price.

ICON Energy Fund Class S (ICENX) is up 8 percent since we added it to the portfolio last year. Demand for energy accelerates with an economic expansion, and we expect to see solid gains as the economic recovery gains traction. It takes energy to make everything, and especially large amounts to make the most vital materials and substances, such as chemicals, plastics, and to run data centers. The best time to invest is when the economy is coming out of a slump, before demand increases.

Aside from the cyclical timing, above average investment returns can be earned over the long run. Over the last 10 years, the Energy Equity Index has produced superior investment returns to that of the S&P 500. That performance is because energy is in the fabric of the economy.

Most energy mutual funds have not been able to match the performance of the Energy Equity Index. However, this fund not only beat the Energy Equity Index resoundingly, it has turned in the best performance – by far – of all energy funds.

ICON management looks for changes within the energy industry to capture value, rather than simply depending on rising prices. Management points out that it has achieved growth even during periods of declining energy prices. The

track record of this fund bears this out. The most recent sanctions directly target Russia's predominantly state-owned oil company, Rosneft. The changing landscape should provide opportunities ahead to capture values.

Pfizer (PFE) is down 4 percent this year, trimming our profit to 81 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on its blockbuster drug, *Lipitor*. However, its future was brighter due to the arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage. Among the most significant include *palbociclib* for advanced breast cancer, a meningitis B vaccine, *Xeljanz* for inhibiting the progression of rheumatoid arthritis.

During the second quarter, sales on Pfizer's top medicines climbed sharply. Sales on *Lyrica* (for pain and fibromyalgia) climbed 16 percent to \$1.32 billion, and sales for its *Pprevnar* vaccines (for pneumonia and other infections) increased 14 percent to \$1.1 billion.

Retail Opportunities Investment Corp (ROIC) is up 7 percent this year, extending our profit to 52 percent. This REIT began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains.

ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. During 2013, ROIC acquired ten grocery-anchored shopping centers for \$368 million. Funds from operations (FFO) increased during the year as these properties were added.

The most recent addition to the portfolio is Fallbrook Shopping Center which should add to earnings immediately. Fallbrook is the typical ROIC's retail center, anchored by supermarkets which bring in traffic.

As new properties are added, along with tenant upgrades, FFO is bound to continue to rise, along with the dividend, and push the price of this REIT upward. Meanwhile, ROIC pays a 4+ percent dividend that lowers its risk profile.

Stryker (SYK) is up 7.2 percent this year, extending our profit to 96 percent.

SYK is best known for its orthopedic devices for artificial knees and hips. SYK also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase, and obesity trends continue, more and more hip, knee, and spinal procedures will be needed.

Stryker's cash-rich balance sheet with \$4 billion of cash and marketable securities, along with its robust cash flow,

gives SYK multiple avenues for continued growth through acquisitions.

In July, SYK announced the acquisition of Small Bone Innovations (SBI) for \$375 million, which will cost SYK \$285 million after tax benefits it will realize from the purchase. SBI has products for trauma and diseases in small bones and joints with \$48 million in sales. In particular, the "STAR" ankle replacement system, three-piece ankle replacement product available in over 40 countries, strengthens SYK's product offering. SBI also has a variety of replacement products for fingers, wrists, and elbows.

Other recent acquisitions include Pivot Medical which provides SYK with a platform of arthroscopic implants to efficiently access the hip with minimal incision. SYK also recently acquired Berchtold Holding, which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems. The MAKO Surgical acquisition put SYK in a leading position for robotic-assisted surgery and the potential for break-through innovations. The 2013 purchase of Trauson Products, China's largest manufacturer of orthopedic implants, also offers access to the Chinese market and broadens SYK's customer base.

Symantec (SYMC) is essentially unchanged this year, trimming our profit to 41 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. If there ever was a more certain growth industry, protection from cyber espionage is it.

Symantec's latest innovation in mobile device management integrates threat-protection for both browser applications and e-mail into one utility that provides protection from viruses, malware, freeware, fraudulent websites, and privacy risks.

SYMC is still undervalued based on the sum of its parts. Valuations range from \$25 to \$28 per share, a premium over the current price of the stock. It is also undervalued based on earnings because its P/E of 12.5 is below the market average.

Tetra Tech (TTEK) is down 10 percent this year, trimming our profit to 63 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet with \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. TTEK also provides energy efficiency and carbon management consulting which are bound to see growth under the new proposed carbon rules announced by the EPA which are aimed at reducing carbon emissions from power plants by 30 percent by 2030.

TTEK recently initiated its first quarterly dividend of 7 cents per share for the second quarter and is buying back

\$100 million of its common stock.

Third Avenue Funds are in our portfolio because the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value (“NAV”).
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 11.4 percent. It has led the pack of all real estate mutual funds during the last 3 years. This is still where the best real estate values can be found in a mutual fund. It is replete with stellar values substantially below NAV with strong growth prospects.

Three months ago, we introduced the **Third Avenue Small-Cap Value Investor Fund (TVSVX)** which invests in companies with small capitalizations using the same value-oriented approach. Small cap stocks perform better than large cap stocks over the longer term because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually profitable. Not only do small caps perform better over the long run, they generally benefit strongly from a recovering economy.

Transocean (RIG) was introduced last month. After a vigorous start, it has declined by 3.36 points and presents an excellent value. At close to 10 times earnings, RIG is trading at the low end of its trading range from the high \$30s to the upper \$50s. Even forgoing the 15 percent foreign tax withholding, the net dividend is above 6 percent.

In July, the company filed for the \$350 million initial public offering for its master limited partnership (MLP), Transocean Partners, to which it will sell a 51% interest in three assets located in the Gulf of Mexico; two ultra-deepwater drillships which are leased to Chevron and one semi-submersible rig leased to British Petroleum (BP).

This sale will unlock the full value of these assets and give RIG a healthy cash infusion.

Transocean is also planning a second MLP called the Caledonia Offshore Drilling Company, to which it will drop down 8 of its rigs operating in the North Sea.

The creation of these MLPs will be highly beneficial to Transocean. The cash infusion will bolster its balance sheet and provide a way for the company to sell assets at full value, much more than could be realized in the open market, while still maintaining control of these assets.

USAA Precious Metals & Minerals Fund (USAGX) is up 29 percent this year. When the economic recovery gets more traction, the money created in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities including precious metals.

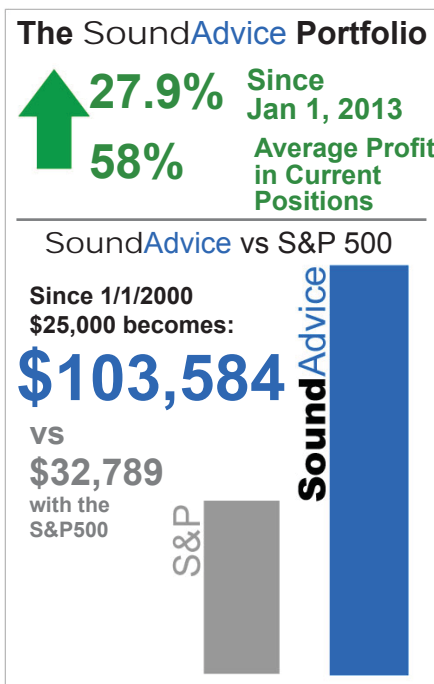
Geopolitical tensions are a positive for precious metals because they are also safe haven assets. An increase in tensions between Russia and the West are likely to be a positive force for this sector.

This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is

the top-performing fund, and has constantly out-performed precious metal equities for ten years.

Xerox (XRX) is up 8.2 percent this year, extending our profit to 54 percent. We have been recommending XRX because it has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). In 2013, the strongest growth came from the expansion into IT services, especially in the healthcare industry where technology is needed to reduce costs. In 2013, these business services represented 55 percent of the company’s total revenue. Generally these services are long-term contracts with high renewal rates, and there is a pipeline of new opportunities.

During the last three years, XRX has repurchased \$816 million of its stock annually. Free cash flow continues to be strong and will be used to continue to buy back more stock in 2014 close to that average. Beyond 2014, XRX plans to repurchase another \$1.0 billion of its stock.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 17.84	4.26%	\$ 19.50	BUY
Equity CommonWealth REIT **	EQC	NYSE	\$ 26.87	3.72%	\$ 28.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 6.59	3.64%	\$ 7.33	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 15.45	3.88%	\$ 17.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.60	2.09%	\$ 33.00	BUY
Diversified Growth						
Pfizer	PFE	NYSE	\$ 28.86	3.60%	\$ 32.00	BUY
Stryker Corp.	SYK	NYSE	\$ 80.00	1.33%	\$ 87.00	BUY
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 27.37	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.04	1.92%	\$ 13.50	BUY
Energy/Natural Resources						
Agrium *	AGU	NYSE	\$ 90.54	2.82%	\$ 100.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 26.07	1.34%	\$ 32.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 43.83	0.75%	\$ 48.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 36.78	3.40%	\$ 40.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 23.63	3.13%	\$ 27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 25.10	1.12%	\$ 27.50	BUY
Transocean *	RIG	NYSE	\$ 40.44	6.31%	\$ 45.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 16.49	0.12%	\$ 18.00	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$ 13.89	0.00%		SELL
Boston Scientific	BSX	NYSE	\$ 12.59	0.00%	\$ 14.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 45.77	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 28.33	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 58.73	0.00%	\$ 65.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 20.87	0.00%	\$ 25.00	BUY
Symantec	SYMC	NASDAQ	\$ 23.17	2.59%	\$ 23.00	HOLD

Notes to the table:

Prices are as of 8/1/2014. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

* Transocean (RIG) and Agrium (AGU) yields are net of the 15 percent foreign withholding tax.

** CommonWealth REIT (CWH) changed its name to Equity CommonWealth REIT and its ticker to EQC.

General Comments:

Our statistics are based on the assumption that \$10,000 is invested in each position. When a new position is added, we assume the same \$10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, we assume another \$10,000 is invested again in that position.

If you are investing in the portfolio for the first time, we believe your performance will be enhanced by deferring purchases in positions that are not in our "Buy" zone.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool the SoundAdvice "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings

and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the SoundAdvice Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the SoundAdvice Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$11.3 million in stocks and to \$1.43 million in houses.

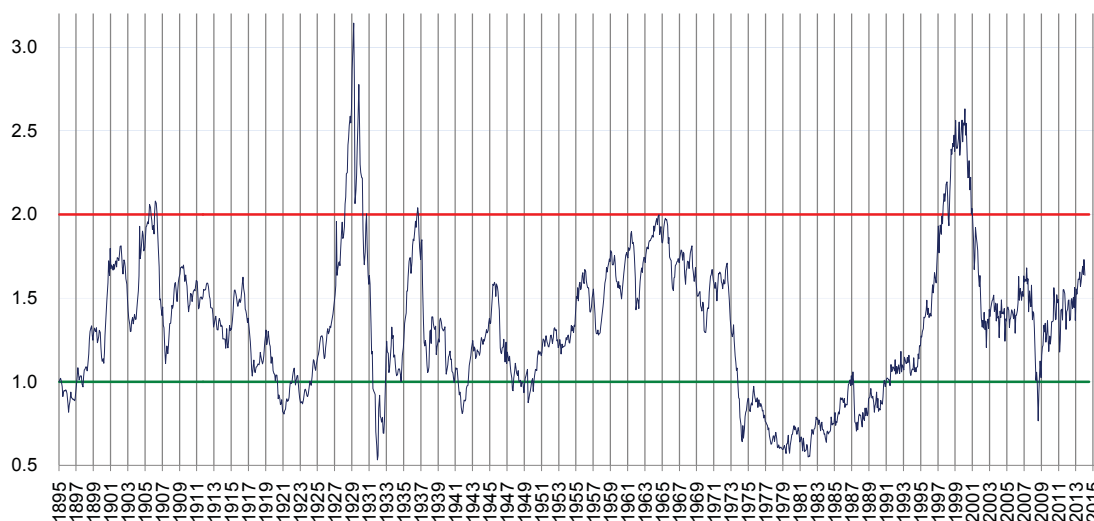
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$450 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

The SoundAdvice Risk Indicator

The latest reading for the Sound Advice Risk Indicator is 1.75. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the Sound Advice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you re-new your subscription.)



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our SoundAdvice Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be $(1.5)/3$ or 50 percent.

When the SoundAdvice Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The SoundAdvice Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 66.7 percent.

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

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100 percent for the fourth month in a row in June 2014 (the latest data available) which tells us that the economy is now strong enough to push up inflation and long-term interest rates along with bond yields.

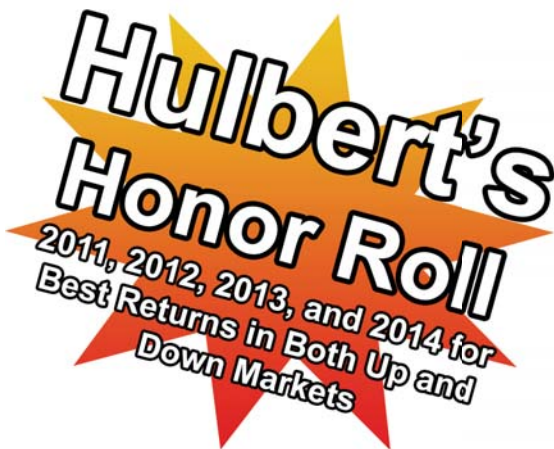
Track Record of the SoundAdvice Diffusion Indexes

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 climbed an average of 34.4 percent. During "Caution" signals, the S&P 500 increased an average of 1.9 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Ave +/-	34.4%		1.9%

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

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