

SOUND ADVICE

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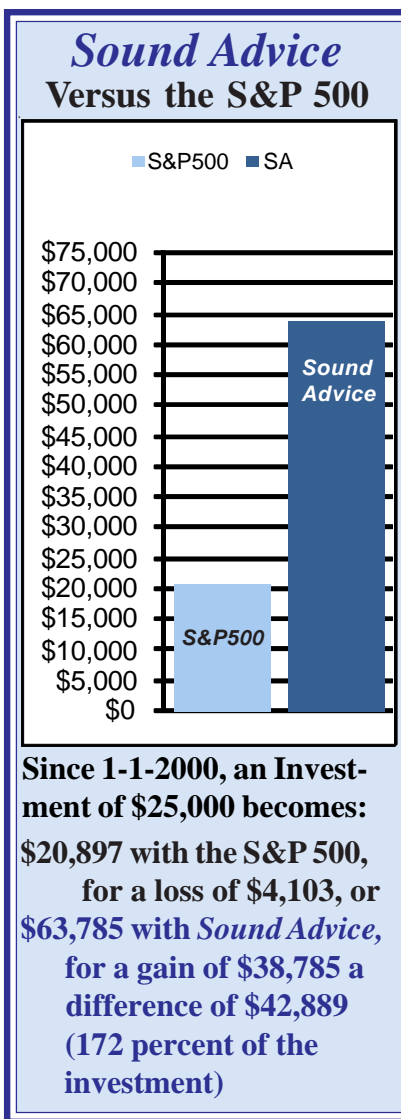
An unemployed Englishman with a metal detector stumbled on a hoard of Anglo-Saxon objects fashioned from 3 pounds of silver and 11 pounds of gold that had lain untouched for 13 centuries. Talk about discovering hidden value! Besides the lucky finder, who endured years of mockery as he wandered the landscape praying for the golden "ping," and the owner of the land, the real winners are sellers of metal detectors, who can't keep up with demand from people inspired by the startling discovery. Same thing with investing. My mail box, when the market starts rising, fills with get-rich pitches from "newsletters" that didn't exist two months before. That same waste of paper and postage, now that the market has taken off, is happening now. My email box is worse, since spam is an almost free way to spread propositions about penny stocks. Today's email includes a pitch for a money-losing motorcycle manufacturer, a technology company that will revolutionize waste disposal in Mexico and an oil company the promoter stops just short of guaranteeing Chinese buyers will snap up. The thing is that some of these propositions do pay off, and like the Anglo-Saxon hoard make those who invested in them rich. On the other hand, hundreds of millions of dollars spent on metal detectors dwarf the value of not just this miraculous Mercian hoard but the total of coins, rings, watches and the odd historically valuable item those wandering souls with metal detectors discover. If you want to get rich from penny stocks, don't buy them. Instead, become a tout and spam the universe.

--Gray Emerson Cardiff

Finding Value When the S&P's P/E is 136.5

Regardless of how profitable being long stocks has been over the last seven months, it remains a day-to-day challenge—even on the good days. *Sound Advice* since March has encouraged subscribers to get more active, and in May noted the start of another Supercycle, the sixth we have tallied since the end of the 19th century. Nonetheless, every weekday at 6:30 AM when the TV starts spewing stock prices and market commentary, I can't help but wonder how it will seem looking backward at 1 PM? Yes, I know, we preach long-term investing, we mock knee-jerk decisions and we, like everyone else, live and die—at least a little—by what is happening right now. How did XYZ close today versus yesterday? It's up? That adds a little spring to our step. It's down? That makes the day drearier. It's human nature.

However, our mood and how we make our investment decisions, though that mood does have an effect, are two different things. When we are sifting through what Wall Street has put on sale, we invariably start with price ratios, that is, how much the market is willing to pay to own a share's worth of a company's cash flow, sales, earnings and book value. In most cases, the smaller the valuation ratio, the more interested we become. Our own experience with low valuation investing is consistent with numerous academic studies about how over the long term low P/E stocks outperform the market. David Dremen has probably done the most to popularize this approach, which guides many value investors



There Are P/Es and There Are P/Es

to low P/E situations. The major difference between most investors and us in how to approach individual stocks is duration.

For example, how often have you read or seen some market expert recommending a stock because it is “trading at a discount to the market?” The Wilshire 5000, which captures the entire market, has a forward P/E of 14.1. Does this mean that a stock that is trading at a smaller P/E is worth owning? Electric utilities, for instance, are uniformly trading at a discount to the Wilshire 5000. Should they be bought indiscriminately? Perhaps, but without some historical perspective (to say nothing of a thorough vetting of its SEC filings) indiscriminant buying based on current P/Es is dangerous nonsense.

Utilities almost always trade at a discount to the market’s P/E, while some sectors, such as technology, almost always trade at a premium. Some sectors turn the low P/E=value formula upside down. Cyclical stocks often sport high P/Es at market lows and low P/Es at market highs, because investors recognize that their earnings are so volatile. Thus, in good times they refuse to push share prices up in lock step with fast rising earnings, hence P/Es are lower, while during lean times, investors don’t push share prices down as quickly as earnings plummet, hence a higher P/E.

Furthermore, individual companies within a sector can command P/Es higher than their peers’ simply because they are considered the elite. For instance, Apple trades at 32 P/E while Microsoft trades at half that. For that matter, even for individual companies, fluctuating earnings and prices can make any single year’s price ratios misleading.

Lining the wall of our office are the last 13 years worth of *Value Line*, which every quarter cycles through reports on about 1700 publicly traded companies. Each report provides at least a decade’s worth of historical data. For us, if we are interested in a company covered by *VL*, research starts with these quarterly reports. We read each year’s reports. We can build a spreadsheet based on the 23 years of sales, cash flow, earnings, book value and other metrics, and then see how current valuations compare to that almost quarter of a century worth of change.

What we are looking for is extraordinarily simple-minded: how little have investors in the past been willing to pay to own the company’s current value? If current price ratios come close to the pittance the market was willing to pay in the past at times of maximum

pessimism, we want to look closely at the company.

21st century investing has little patience with this approach. Indeed, Wall Street seems to have trouble holding in memory more than the past few months. *Morningstar* on its website, to its credit, does provide 10-year histories for price ratios. Yale’s Robert Shiller, who has been right about equities and housing over the last 15 years, when he talks about valuations, relies on a modified P/E, which uses inflation-adjusted average earnings over the previous 10 years as a denominator. Shiller’s approach washes out much of the volatility earnings demonstrate.

But most value investors seem indifferent to the problem, and restrict themselves to how a company’s current P/E compares to the general market. How much more informative would it be if in addition to the ubiquitous Price & Volume charts that technicians love, there were widely available similar graphics for Price/Earnings, Price/Sales, Price/Cash Flow and Price/Book. How about a chart of changing dividend yields? Now that would tell us something important.

What we do not expect to see is some catalyst or trigger that could push the prices of low valuations stocks higher. Frankly, if a trigger is evident to us, it is obvious to most observers, which means it is built into the existing price. Leave the future to the future. All we want is assurance that the company can survive the tough times they are experiencing (the balance sheet and cash flow statement provide that assurance). If a low valuation company remains sound—that is, it’s not making slide rules, just as cheap calculators are sweeping slide rules off the desk—we rarely can resist.

But what do you do in a market such as this when most historical landmarks are obliterated? For instance, because of deep recessionary write-offs and weak sales, trailing earnings for the S&P 500 are \$7.51, which translates to a P/E of 136.5 (the historical average is just under 16), which shouts that for the biggest cap stocks (note the Wilshire’s 14.1 P/E) the market considers current earnings an aberration. In any case, a triple-digit P/E can’t persist. Either earnings must rise, or the S&P’s price must fall. However, individual stocks present a different profile, and there are ample opportunities.

One strategy is to look for companies with hard -to-value assets, such as **Leucadia**. In fact, we think that holding companies with complex balance sheets can be attractive, something we will be pursuing in future issues. In the meanwhile, so far, so good. **SA**

Three Sector Funds

This issue completes our review of funds in the portfolio, looking this time at three sector funds: The **Gabelli Global Telecommunications Fund**, the **USAA Precious Metals & Minerals Fund** and the **PowerShares Water Resources Fund**. The Gabelli fund, up 18.4% in 2009, trails the pan-market Wilshire 5000's 20.7%, but compares well to the iShares Global Telecom ETF's (IXP—NYSE) 8.4% performance. As the chart on page 4 shows, the precious metals fund's 41.6% gain nicely outpaces its benchmarks. The Market Vectors Gold Mining ETF (GDX—NYSE), for example, is up 27.7%. The water resources fund has advanced 17.6% and lags the iShares Dow Jones Industrial Sector Index's (IYJ—NYSE) 19.2%.

At the same time, we are removing the **Federated Prudent Bear Fund** from the portfolio, since it's inconsistent for us, when we are bullish about the market's long-term prospects, to include a fund that essentially is short the market. An argument can be made to retain the fund as a hedge, not only because its portfolio is short the market, but also because its handful of long positions are weighted toward junior precious metals miners, a sector that merits representation in this environment. But we have the USAA precious metals fund and, more importantly, since we are always 100% invested and were the market to dive, having a single hedge among the 39 positions in the portfolio would be as useful as holding a teacup should we need to bale out a rowboat swamped in a hurricane.

TELECOMMUNICATIONS

The **Gabelli Global Telecommunications Fund (GABTX)** invests in an area that traditionally was viewed as non-cyclical, since even during economic downturns the necessity of phones in the home and in commerce guaranteed solid cash flow and reasonable dividends. However, this stability gets tested when the economy tanks. In reality, telecom company revenues move in tandem with GDP growth. Though during the global recession telecom revenues remained more stable than, for instance, jewelry sales, in the industrialized nations they stagnated and in emerging markets, which had provided much of the oomph in telecom's global growth, they declined. Magnifying this cyclical aspect

has been an explosion in wireless voice and media transmissions that has placed phone companies as a primary go-between in the digital revolution.

Starting in the late 1990s, the industry began to separate itself from the dowdy landline business. The drivers for growth are cable television, Internet service, and mobile devices. Not surprisingly, as telecom funds proliferated during that period, they tended to perform more like tech funds, which often means they lost contact with value investing, and replaced buying at a discount with buying fast growth.

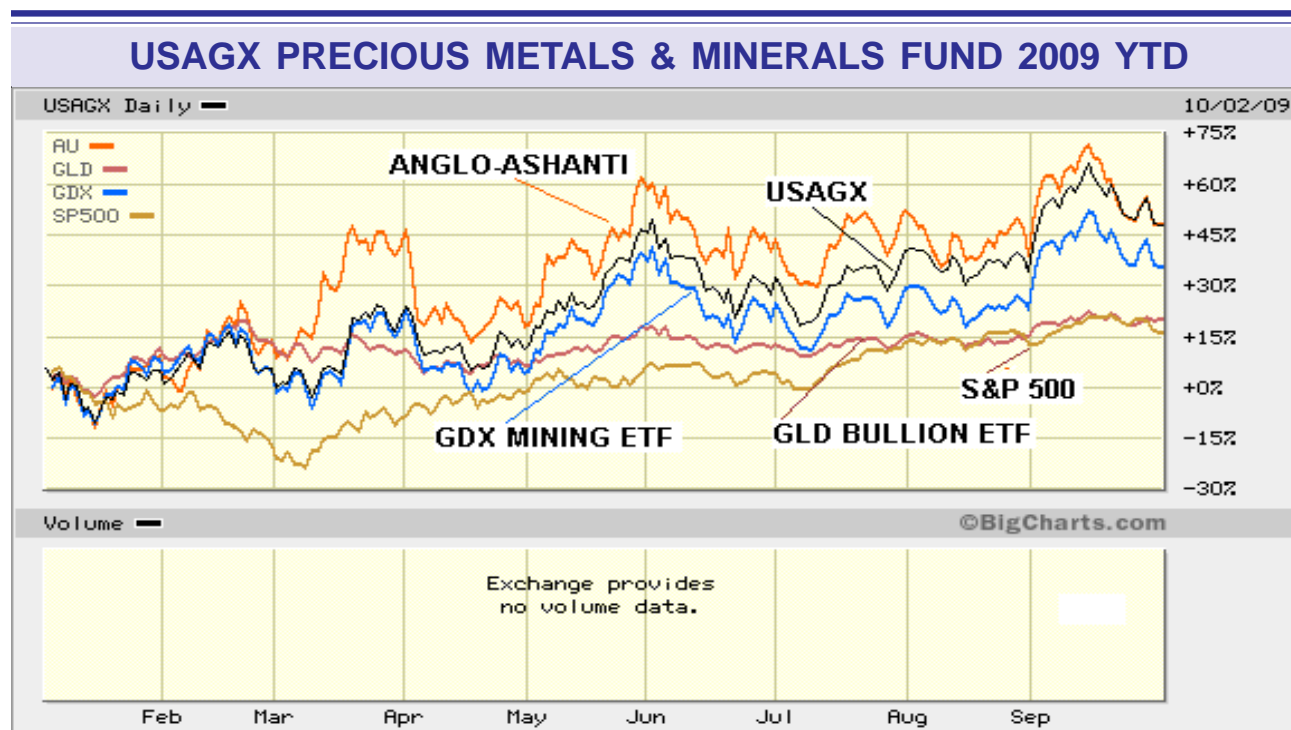
On the other end of the spectrum stands the Gabelli Global Telecommunications Fund, a pioneer in the sector, which debuted in 1993 and follows the value-oriented approach of its founder, Mario Gabelli. Over the seven years the fund has been in our portfolio, it's performed second only to the T. Rowe Price telecom and media fund, though if we include pure wireless funds' performance both funds would move down.

2008 was terrible for most sectors, uglier for telecom funds, and even more so for GABTX, because of its exposure to some of the most ravaged emerging markets like Russia and Latin America. In 2008, the MSCIAC World Telecommunication Services Index, the benchmark for the Gabelli fund, dropped 35.6%, a bit less than the S&P 500. GABTX fell 40.6%, which leaves plenty of room to play catch-up in a recovering market.

Gabelli seeks profits in companies whose private market value, that is, what an informed buyer would be willing to pay for a company, exceeds the current market price. The wider that gap, the greater the potential profit. However, the fund asserts that it does not buy companies merely because they appear cheap. Instead, unlike for us, there needs to be some catalyst the managers perceive that will turn potential into tangible value. As Gabelli noted in his letter to shareholders in September 2008, after a year of declining share prices but before the real dive would occur in the following weeks, merger and acquisitions activity had stalled, credit was unavailable, and valuations were plummeting, which, at that time, from the fund's perspective seemed to be creating "compelling valuations."

If we compare the most recent SEC filing that shows the portfolio as of June 30th to where the fund stood in June 2008, before the roof fell in on the market and

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economy, there's remarkably little change. Aside from small shifts in weighting, shareholders still retain a nice mix of North American companies (the dominant position is Rogers Communications, a Canadian telecom company at 4.5% of assets) that account for 42.5% of the portfolio and heavy exposure (30%) to Europe (both western and eastern) in addition to 10% positions in Latin America and Asia ex-Japan and 5.4% in Japan. The fund does not currently hedge its foreign exchange exposure, a plus going forward, since we anticipate further weakening in the dollar.

There is another dimension to the portfolio that extends telecommunication beyond phone, cable and satellite companies. Gabelli personally has always been keenly interested in media companies in part because like **Time Warner** before spinning of its Time Warner Cable they held cable assets but also because communications and content are inextricably linked. Hence, GABTX holds significant positions in Yahoo! as well as in several of John Malone's Liberty Media offshoots.

Why should you own GABTX? The most obvious reason is the pivotal role telecom plays that can only expand in the future, especially in the emerging markets. A revival of economies around the world will boost communication consumption, especially for businesses. The fund takes its "global" mandate seriously, another plus for diversification. Gabelli's focus on value provides an anchor in what can be a volatile sector.

PRECIOUS METALS

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

USAGX, and for that matter, all USAA funds in the past have been difficult at times for non USAA members to buy. For a period, USAA tried to restrict purchases to its own membership, which requires being an active or retired member of the military, or having an employment history with other government agencies. There were ways to get around this requirement, but it was not simple. After stock prices last year collapsed,

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USAA decided it could deal with “outsiders.” You can buy USAGX directly from USAA but you can also go through brokers such as Vanguard, TD Ameritrade and Pershing, though others, like Schwab and eTrade, do not handle these funds.

If you own precious metals funds, you must be willing to tolerate volatility, and not just garden-variety volatility. At the start of 2002, gold traded at just under \$278 an ounce, and over the next seven years has nearly quadrupled. Gold bullion over the last 12 months has been as cheap as \$712.50 in late October and, after pushing through \$1000 has been bouncing above and below that threshold.

Since the start of 2002, USAGX, when distributions are factored in, has increased nearly seven fold. Why do mining stocks move more violently than the underlying commodity? Mining stocks magnify moves in the underlying metals not just because rising (or falling) bullion prices push

the embedded value of unmined reserves up or down but especially because changes in the price of gold create higher (or lower) operating margins, especially for producers with high fixed costs.

For example, imagine you are offered the opportunity to buy shares in either the lowest or the highest cost gold mining company. Over the long term, owning the most efficient producer is the proper choice. However, at the start of a boom in gold prices, owning the higher cost producer will be far more profitable. If the low-cost producer spends \$200 to produce an ounce of gold and the high cost producer \$450, consider the impact on profits when the price of gold moves from \$712.50 to \$1000. Both are now making \$287.50 more per ounce. The low-cost producer's profit increases by 56% but the high-cost producer's profits more than double.

Speaking broadly, the most efficient gold miners are in North America and the least efficient in Africa. There are more and less efficient and inefficient miners to own in both regions.

Mark Johnson, who has managed the fund for the past 15 years, is a value-oriented opportunist, and historically has favored low-cost mid-sized miners, which provided both the good cash flow even if gold prices remained weak and growth prospects. He has also maintained a low turnover ratio (USAGX last year had a 28% turnover rate versus 75% for his competition). But Johnson does

make changes at what he perceives as turning points. Thus, in 2001 as gold was bottoming, his turnover rate hit 51%. A similar, if not as major, revision has occurred over the last 12 months, even though the shifts are not apparent by looking merely at the fund's commitment to broad sectors.

For example, though gold this year constitutes 79.8% of the portfolio (up from 75.5% last year), it is the types of gold mining companies that have changed significantly. In 2008, as usual, the dominant positions were low cost North American miners like Goldcorp and Newmont. This year African miners, high cost

producers generally, hold those top slots. AngloAshanti, which pulls 40% of its gold from deepshaft South African mines, is a high cost producer. Randgold, which has moved from 2.3% to 4.9% of the portfolio, mines primarily in West Africa also is a high cost producer.

Look at the chart on page 4 to see how USAGX has moved in relation to the SPDR Gold bullion ETF (GDX), especially since gold itself bottomed last October. We've also thrown in the price movement for AngloAshanti Gold (AU—NYSE).

The only reason to own high cost producers, as we noted, is an expectation that gold prices are on a sustainable rise that will have their biggest impact on the profits of high cost producers. The bull market in precious metals at every step has been deprecated as a fantasy, but after almost eight years that cavalier rejection is losing its luster. Johnson has shown a talent at making the right decisions during his tenure, and, since we consider funds managed by industry veterans superior to index funds, we cannot think of a better way to play gold and precious metals than USAA Precious Metals and Minerals Fund.

WATER

The Powershares Water Resources Fund (PHO—AMEX), an exchange-traded fund (ETF), aims to provide a way to invest in the water industry. As the fund explains “The Index seeks to identify a group of companies that focus on the provision of potable water, the treatment of water, and the technology and services that are directly related to water consumption.” Though investors and the media,

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when considering natural resources obsess on energy, gold and other metals, if they wanted to focus on the one resource the world cannot survive without, they should consider water. But there is no spot market for water, and when compared to other resources such as oil, corn or iron, water is priced as if it has almost no monetary value.

Consider that here in California, much of which has a near desert environment, local water utilities during a period of unusual drought, now charge about a penny for three gallons of the best drinking water Sierra snow melt can provide. In some cities, water to homes and businesses is not even metered. Compound this profligate use of water with simultaneous growth in population and demand, and add in pollution issues, and the remarkable value of companies which provide water or solve water-related issues becomes apparent. In the United States there are approximately 55,000 water delivery systems and 16,000 waste water facilities that will require over the next 15 years \$1 trillion in repairs and maintenance. This does not even take industrial water needs into account. Demand for potable water increases at a rate roughly twice that of population growth. Leaking pipes nationally lose 60 billion gallons of water per day.

And the challenges faced in the United States are relatively minor compared to dire circumstances in places like China, Latin America and other emerging economies. Beijing estimates that a third of its rivers and lakes are too polluted for industrial or agricultural use, which compounds the drastic demographic challenge for China, which holds 20% of global population but only 7% of the potable water.

The story is compelling, and Wall Street always stands ready to meet such thematic demands, hence the creation of a handful of watercentric funds. PHO at present is the best way to invest in what should be an explosion in demand for water resources services.

However, there is something of a gap between the *concept* of a water resources fund and reality. Indeed, the very notion of a “water industry,” is open to challenge, or to be more fair to the fund, it is challenging to create a fund dedicated to a sector in which few publicly traded companies are entirely or even dominantly devoted to water resources.

There are companies like Mueller Water (4% of the

portfolio) that produces valves and Insituform (3.1%) that relines sewage and fresh water lines, which focus on water, but even an environmental engineering company such as **Tetra Tech** (4%), which we hold in the *Sound Advice* portfolio, derives income from other lines of business. In many cases, companies in the PHO portfolio have modest ties to water. For example, Valmont Industries, the largest non-utility position as of September 21st (5.2%), derives only about a quarter of its revenues from production of irrigation equipment. Flowserve, the second largest position (4.8%), derives 6% of its revenues from the sale of its valves, pumps and mechanical seals to the water treatment industry.

Though this is an “index” fund, do not conclude that the portfolio is relatively fixed. In fact, the underlying index changes regularly, because the index manager has wide latitude to drop, add, or reweight his positions to reflect his market perspective.

Thus, last year Stephen Hoffmann, who developed and maintains the fund’s underlying index, sharply decreased exposure to water utilities and beefed up exposure to water technology positions. Hoffmann anticipates that his index will continue to evolve along with the water resources industry as new companies emerge and existing companies get more deeply involved in the business. Last year, General Electric, which has made several acquisitions involving water technology and hardware, was part of the portfolio, but has dropped out as Hoffmann has been able to find more water-focused positions.

When considering PHO, investors should recognize that while the fund matures and evolves toward a more concentrated water portfolio for the moment it should be considered primarily as an investment in industrials, since for most of the portfolio’s constituents the non-water businesses dominate their revenues and operating profits.

In the meantime, we like the fund not just for its actual and potential involvement in water resources but also because it’s essentially about infrastructure, a sprawling business that should boom over the next decades not just because of stimulus projects (domestically they should be more evident in 2010) but because at home infrastructure has been benignly neglected and in countries like China and India have hardly been addressed. **SA**

Portfolio Updates

September confounded market “wisdom” by producing positive results. The *Sound Advice* portfolio was heading for another market-beating performance. However, October’s first two days took away almost all of what the averages had built in the previous month, and were particularly hard on our portfolio as investors took profits on some of the strongest performers. Since the last letter was priced, the Dow is up 0.5%, the S&P 0.9%, the Nasdaq 1.5% and the pan-market Wilshire 5000 1.1%. *Sound Advice* gave back 1%. This is the first time since the March lows that we have trailed our benchmarks. Through this issue, we are up 36%, roughly quadruple the Dow, double the S&P 500 and Wilshire 5000, and 20% higher than the techcentric Nasdaq.

Looking at the two funds we introduced in last month’s issue to replace same sector Icon funds, we see that the **Fidelity Select Natural Gas Fund** is up 5.7% as natural gas bounced sharply off its low, and the **Davis Financial Fund** is up 1.1%.

Among the laggards that tempered our performance, the most prominent was **Xerox**, which until earlier this week had been cruising along with the rest of the technology sector, and was on track for an 11% gain for the month. Instead, it’s contributed a 14.8% decline after announcing it wanted to buy Affiliated Computer Services for \$5.6 billion (including debt). Xerox must borrow \$3 billion to complete the financing. Clearly investors were upset by the deal, perhaps because Xerox had spent the last few years reconstructing its balance sheet whose woeful condition had brought it to the brink of bankruptcy. Now management is taking on debt again. The bid for ACS, we expect, will bring a credit downgrade for XRX. Why did Xerox’s new CEO, Ursula Burns, propose the biggest acquisition in company history? She recognizes that the printer business, though crucial to the company’s future, needs to be leveraged through service-oriented businesses. Burns is doing, as other tech companies’ CEOs whose businesses are anchored in hardware (most recently Dell, a computer manufacture have done, which

announced last week it was acquiring Perot Systems, an IT company, and last year when Hewlett Packard, another hardware maker, bought EDS, another IT company).

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Frankly, we wonder what took Xerox so long to grab an opportunity that we anticipated in 2006 when we added XRX to our portfolio. At the time, we suggested that Xerox would evolve as had EDS (which we also owned) from being a hardware company to providing all sorts of IT support. ACS, which is built around providing support to other companies, mostly clerical and billing tasks, fits nicely with Xerox’s strengths in printing and record organization. Furthermore, unlike Xerox, which garners nearly half of its sales outside the U.S., ACS gets only 10%, an obvious opportunity for Xerox.

Also, as is the case with Xerox, much of ACS’s revenues are recurrent, that is, its clients are on long-term contracts that reflect how tied they are to ACS. Xerox is buying built-in growth on which to expand business. We suggest Xerox is now a stronger Buy as the market takes a dim view of this positive deal.

UnitedHealth, the HMO, took a beating this month as investors reaped profits taken after the world decided that any healthcare reform coming out of Congress won’t create a public option that would put real pressure on medical insurers to make costs (and profit margins) skinnier. UNH is down 15.9% since the last letter. It has gone from being attractive once opinion shifted away from a public option to very attractive now that it looks like the result of healthcare

Sound Advice Portfolio for October 2009

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Duke Realty Cumulative Preferred	DRE.PRO	NYSE	\$23.93	8.75%	N/A	SELL
HRPT Properties	HRP	NYSE	\$6.73	7.13%	\$7.20	BUY
Public Storage Cumulative Preferred	PSA.PRM	NYSE	\$22.32	7.42%	NA	SELL
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$46.88	0.23%	\$56.00	BUY
Boston Scientific	BSX	NYSE	\$10.01	0.00%	\$14.00	BUY
CarMax	KMX	NYSE	\$19.34	0.00%	\$24.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$18.92	4.33%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$30.39	7.41%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$88.58	2.05%	N/A	BUY
Fastenal	FAST	NASDAQ	\$36.46	1.92%	\$46.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$17.85	1.85%	N/A	BUY
Honeywell	HON	NYSE	\$35.60	3.40%	\$42.00	BUY
Johnson & Johnson	JNJ	NYSE	\$59.73	3.28%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$22.99	0.00%	\$30.00	BUY
Mattel	MAT	NYSE	\$17.95	4.18%	\$20.00	BUY
Microsoft	MSFT	NASDAQ	\$24.96	2.08%	\$30.00	BUY
Molson Coors Brewing	TAP	NYSE	\$47.42	2.14%	\$52.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$12.26	0.00%	\$14.00	BUY
Perrigo	PRGO	NASDAQ	\$33.69	0.65%	\$38.00	BUY
Stryker Corp.	SYK	NYSE	\$43.93	0.91%	\$48.00	BUY
Superior Industries	SUP	NYSE	\$13.60	4.71%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$26.33	0.00%	\$35.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$43.74	0.42%	N/A	BUY
United Parcel	UPS	NYSE	\$54.94	3.28%	\$60.00	BUY
UnitedHealth Group	UNH	NYSE	\$24.28	0.12%	\$32.00	BUY
Wal-Mart Stores	WMT	NYSE	\$49.08	2.22%	\$60.00	BUY
Xerox	XRX	NYSE	\$7.32	2.35%	\$10.00	BUY
Energy/Natural Resources						
Anglo-American PLC****	AAUKY.PK	PINK SHEETS	\$14.93	0.00%	\$20.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.00%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$29.46	5.70%	\$35.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$15.82	0.50%	\$19.00	BUY
Transocean	RIG	NYSE	\$81.90	0.00%	\$90.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$29.68	0.03%	N/A	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	\$15.24	1.78%	\$19.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	8.80%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$28.30	15.41%***	\$34.00	BUY
Liberty Global	LBTYA	NASDAQ	\$20.84	0.00%	\$28.00	BUY
Maxim Integrated	MXM.PK	NASDAQ	\$17.17	4.66%	\$22.00	BUY
Federated Prudent Bear Fund***	BEARX	800-711-1848	\$5.84	0.00%	N/A	SELL
Symantec	SYMC	NASDAQ	\$15.98	0.00%	\$19.00	BUY
Time Warner	TWX	NYSE	\$29.63	2.56%	\$34.00	BUY
Western Digital	WDC	NYSE	\$35.33	0.00%	\$39.00	BUY

*Prices as of the market close on Friday, October 2, 2009

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

Note that all fund distributions fluctuate annually.

***Dividend Deferred

****Note change in ticker symbol

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

Sound Advice: Portfolio Updates for October 2009

reform will expand the population of insured Americans and but won't have to contend with a competitor that doesn't need to satisfy Wall Street. For reasons not obvious to us, investors seem indifferent to apparently positive circumstances at UNH.

Boston Scientific, which is having a good year, had a bad September, dropping 11.9%. On Tuesday, BSX announced it had settled a long-fought patent battle over stent designs. BSX will pay **Johnson & Johnson** \$716 million to end the dispute. But beside that, there has been nothing to explain the fall in Boston shares. We're still fans of the company.

JNJ itself drifted down 1%, while **Perrigo**, the OTC generic and prescription drug company, jumped 13.4%. PRGO is one of the few healthcare stocks not to feel any pressure from the prospects of healthcare reform. The only imaginable negative would be a decline in self-medicating by people who would be covered by some minimal form of insurance and thus able to see a doctor. During the recession, however, Perrigo's house-branded products are gaining market share. Who needs to spend top dollar for national brands when the same formulations are available at a third less? For retailers, Perrigo's products generate higher margins than do national brands. With concerns rising over a robust flu season that would increase demand for OTC drugs, investors decided PRGO was a good investment.

Stryker, our last medical stock, is up 1.1% on no news. The shares have been recovering nicely after a poor earnings report back in July knocked shares down enough that we suggested it was particularly attractive, since, at least as we saw it, Stryker's short fall, which came from its hospital supplies business, was the result of hospitals trying to spend as little as possible on both supplies and equipment. Eventually inventory demand and the need to upgrade facilities will force customers to purchase. If investors insist on responding to every twitch in sales, they will sell into such news. If investors look behind the numbers, selling pressure that produced lower prices should be seen as an opportunity. Since the July low, SYK has outpaced the indexes.

Tetra Tech, the environmental remediation company with particular interest in water resources, dropped 9.7% on nothing but a steady stream of new contracts, the biggest of which is for \$500 million. These bode well for TTEK's future. Our only thought on why TTEK has fallen 15% since mid-August is that the

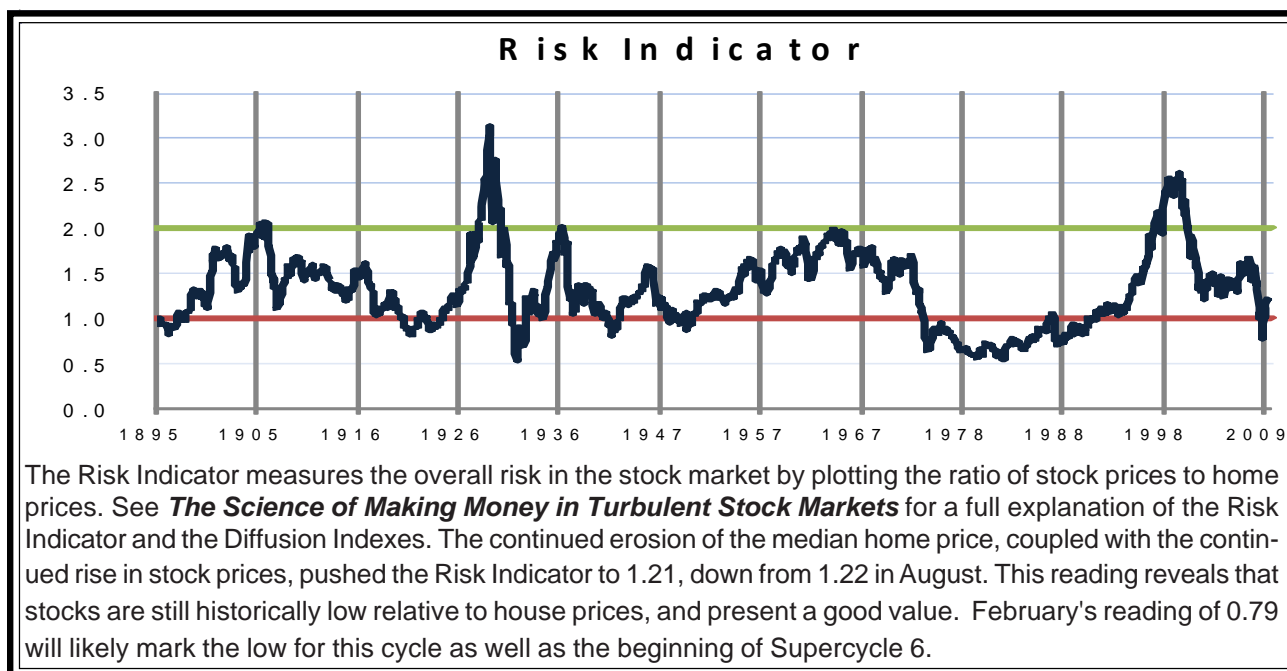
August price represented a new all-time high for the shares. Perhaps investors decided to take their money and run. We think TTEK will move back and through that high.

At the other end of the performance spectrum, a big winner on excellent quarterly earnings and an improving outlook was **CarMax**, which last week blew through analysts' estimates of earnings. Apparently, the cash for clunkers program did not siphon off buyer interest in used cars. One notable fact about KMX's earnings: they included 10 cents a share, the result of an upward revision in the value of subordinated bonds in its lending division. As with the ability of Xerox to secure lending to make the ACS deal work, KMX's decision to up the value of shaky securities suggest better times for the debt market. Indeed, ACS, Xerox's acquisition target, was on the way to a private equity sale in 2007, but it fell apart along with the ability for companies to borrow money to finance such deals.. Since the last letter, KMX is up 11.9%, the second best performer this month in our portfolio.

Time Warner also has had a good month, up 5.6%. The shares jumped last week, perhaps in response to rumors of a potential deal between **Comcast** and GE to combine their cable network assets. For TWX, prospect of such a deal suggests its own cable networks suddenly have greater worth. But for Comcast, the terms of the deal were a damper, and shares fell, down 6.7% for the month, all of the damage coming on news of the rumor.

REITs continue to enjoy a strong year. **CGM Realty Fund** posted a 5.8% gain, and **HRPT Properties Trust** tacked on another 2.3%, though both were considerably higher earlier in September. Our two REIT preferreds also moved higher since the last letter: **DRE-PO** is up 10.1% and **PSA-PM** 5.1% (both include quarterly dividends). At two points,, the Duke Realty preferred ran above \$25, which made no sense on the day. On the next day, the shares fell back under \$24. We are selling both preferreds, since as they approach \$25 they have done as much as we could have hoped. For those who own the shares, we encourage you to retain them as income vehicles, but for *Sound Advice's* purposes, we prefer to identify growth opportunities. DRE is up more than 50% from its initial recommendation, while the more conservative PSA is up 17.4%. Note we are also selling the **Prudent Bear Fund**. See page 3 for our rationale. **SA**

Sound Advice Market Indicators for October 2009



The Sound Advice Diffusion Indexes

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

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

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

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

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each “Aggressive” signal, the S&P 500 produces an annual return of 19.4 percent. During “Caution” signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

Continued Strength

The hand picked leading indicators that comprise our Diffusion Index of Leading Indicators, which are the most sensitive to changes in economic conditions, have shown unusual strength in recent months, rising 2.02 percent in August (the latest reading available), which followed an increase ranging from 2.71 percent in April to 6.8 percent in June.

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

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