# Sound Advice

**Hulbert's Honor Roll in 2011, 2012, 2013, 2014**
For the Best Risk-Adjusted Returns in Both Up & Down Markets since 2000

Advising Investors for 25 years | October Issue | October 2, 2014


If one thing is certain when it comes to investing, it is that things don't remain as they are for very long. This is especially true when the current situation simply doesn't make sense.

After adjusting for inflation, 10-year Treasury bonds yield less than one percent.

Who in their right mind would lock-in an investment returning less than one percent in real terms for a ten-year period?

The obvious answer is no one. Investing in 30-year bonds makes even less sense.

Warren Buffet said on CNBC this morning that he doesn't own any bonds because they don't make sense now.

Capital is just being parked temporarily in long-term bonds as a safe haven. However, we know that interest rates will be rising, it is just a question of how soon. Members of the Federal Reserve are arguing about whether the rise will start in early or mid-2015.

Financial markets anticipate the foreseeable future, and the bond market is no exception. During the next few months, we are bound to see bond yields moving upward, anticipating the inevitable.

***-Gray Emerson Cardiff***

# A Ticking Bomb

For nearly 6 years, the Federal Reserve has had interest rates at emergency levels in order to bail out the economy from the 2008-09 recession. In view of the considerable economic improvement since then, the debate within the members of the Federal Reserve is heating up regarding when it will be appropriate to abandon emergency interest rates and let them rise to normal levels.

The Federal Reserve is in a quandary. On one hand, it will have to raise interest rates relatively soon as the US economy and job market continue to improve. In addition, everyone knows it is ending its massive Treasury bond-buying program under the quantitative easing (QE) program which will remove the last of the support for Treasury bond prices. Moreover, the Fed has collected a large portfolio of Treasury bonds during QE, about four times normal, which it will need to sell at some point which will put upward pressure on bond yields. It is like a ticking bomb, and the longer the Fed waits to let interest rates seek normal levels, the bigger the bomb gets.

On the other hand, the Fed doesn't want to spook the financial markets because a sharp rise in market interest rates right now could impede progress and may even derail the economy. The only way out of the quandary is to project a slow and gradual rise in interest rates that will begin some time in the future and make it "data-dependent" so the timing can be vague, so no one panics right now.

Federal Reserve's official forecast projects the benchmark Federal Funds rate will increase from zero currently to 1.2% by the end of 2015 and to 2.5% by the end of 2016. Beyond that, officials project that the Federal Funds rate could settle in at 3.75%.

To reach 1.2 percent by the end of 2015, the Federal Funds rate will need to start increasing form its current rate of zero by the end of January, 2015, and increase an average of 0.0050 percentage points (0.5 basis points) during each trading day. Continuing those daily increases during 2016 brings the Federal Funds rate to the Federal Reserve's target of 2.5 percent.

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.

As far as the timing is concerned the best forecast we have to go on is that of the Federal Reserve itself. At the very least, Treasury bond yields should move in tandem with the Federal Funds rate. That means long-term Treasury bond yields will rise from 3.16 percent today to 4.36 percent by the end of 2015, and to 5.57 percent by the end of 2016.

We can construct a model of these ETFs based on the Federal Reserve's forecast. 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.

If we assume that the ascent in interest rates will not begin until the end of January in accordance with the Federal Reserve's forecast, we may see these ETFs erode until then. As we have illustrated in prior issues, there is an erosion factor with these ETFs because they decline slightly more on downswings than they rise on equivalent upswings in bond yields, and the erosion factor is more pronounced with leverage. With bond yields at absurdly low levels, there is not much room for declines, but they could churn up and down, rising say, 5 basis points one day and declining the same amount the next. Based on history, this would be a high degree of churning and it would be unusually detrimental.

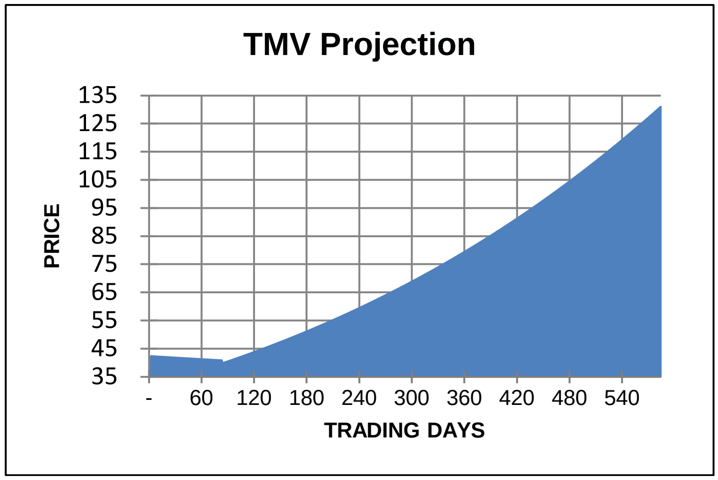
This churning would erode TMV's price the most, by 4.6 percent, because it uses the most leverage. TBT would erode 2.3 percent, and TBF would erode 0.74 percent. Then, this erosion would be followed by steady price increases in all three ETFs, along with rising interest rates.

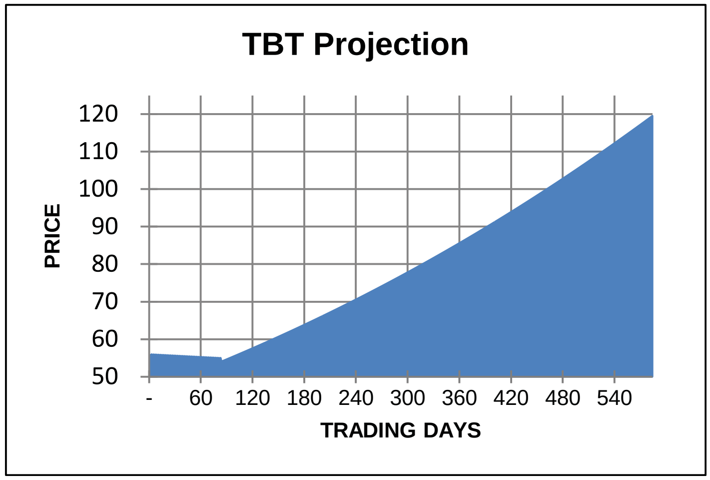
TMV would rise to $131 by the end of 2016, slightly more than three times its current price. The chart to the right shows the pattern, including the erosion until January.

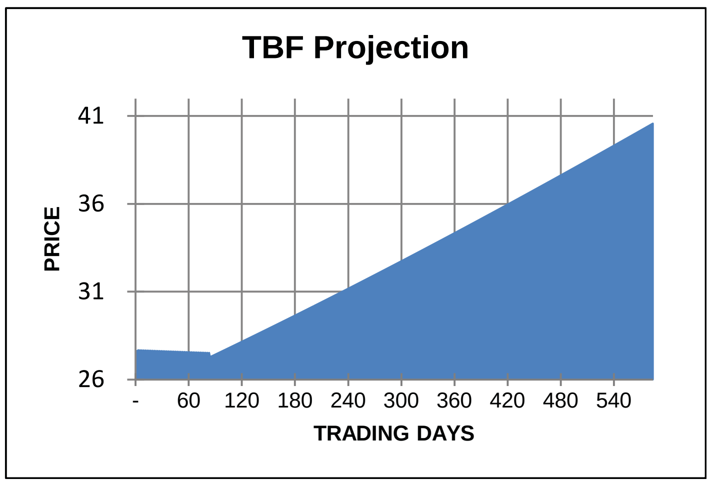
TBT would rise to $119 by the end of 2016, slightly more than twice its current price. The chart to the right shows the pattern.

TBF would rise to $40.5 by the end of 2016, which is 47 percent greater than its current price. The chart to the right shows the pattern.

While these ETFs are no-brainers after a recession because interest rates always rise, the ride has been rougher than we first anticipated. However, even though the Federal Reserve's forecast calls for a gentle increase over a long period, it would still push up the prices of our No-Brainers substantially, and demonstrates the profit potential of these ETFs. Also keep in mind that nobody within the Federal

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Reserve is debating whether or not interest rates will rise, only about exactly when.

We should also keep in mind that the Federal Reserve projects the "normal" Federal Funds rate to "settle in at 3.75%." That brings long-term Treasury bond yields to 6.8 percent assuming a tandem rise with the Federal Funds rate, and potentially larger profits for these ETFs.

At any rate, we continue to believe it is bound to be worth the ride.

## Portfolio Updates

With our Diffusion Index of Lagging Indicators hitting 100 percent recently (see page 11), we are operating with caution. That means we are being more selective with our recommendations. We have positioned the *Sound Advice* portfolio for an improving economy, along with increasing inflationary pressures and rising interest rates that an economic expansion typically fuels.

Our REITs and real estate stocks and funds are bound to be net beneficiaries. When interest rates start pushing up mortgage rates, it will be as a result of an expanding economy and the corresponding increases in rental rates should more than compensate. These, along with our other hard-asset stocks and funds, should also benefit from the rising inflationary pressures.

Although energy stocks and mutual funds have been languishing under soft oil prices, ultimately they are bound to bring attractive profits because energy is woven into the fabric of the economy.

Value stocks have been among the better performers at this stage in past cycles, and our value-oriented approach should continue to pay off.

Having covered our No-Brainer ETFs, 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. See our website for live pricing.

**Agrium (AGU)** is down 4.1 percent this year, trimming our profit to 657 percent.

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.

Agrium's $2 billion expansion to its Vanscoy potash operation will eventually add 40% capacity, and the completion of the project means more free cash flow will be available to return to shareholders.

It looks as though potash prices have bottomed and nitrogen margins are improving. In addition, the retail division continues to grow at a healthy rate. AGU has a solid dividend yield and is undervalued at close to 10 times the expected 2015 earnings of approximately $8.75.

**Associated Estates Realty Corp (AEC)** is up 12.6 percent so far this year, extending our gain to 31.3 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.

Although AEC has since risen in price, so has the value of its real estate portfolio. We value the equity of AEC's apartment portfolio at approximately $28 per share, considerably greater than the current stock price. In September, AEC raised its annual dividend to $0.80 per share. It remains a stellar value with a nice dividend.

**Boston Scientific (BSX)** is down 1.4 percent so far this year, trimming our profit to 25 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.

For example, in September, BSX announced that it received approval from European authorities for its Vercise Deep Brain Stimulation system, used for treatment of a disorder called Essential Tremors which causes involuntary shaking and is 20 times more common than Parkinson's disease. This is the first system designed to offer precise neural targeting, allowing physicians to customize therapy. It also features a rechargeable battery that can last 25 years.

Also in September the successful results were published regarding BSX's self-expanding metal stents (FCSEMS) in the treatment of biliary obstruction in benign bile duct strictures.

In addition, new September data from the clinical trial program of BSX's Lotus Valve System continued to demonstrate strong performance as a less invasive treatment for patients with severe aortic stenosis who are considered high risk for surgical heart valve replacements.

**Chesapeake Energy (CHK)** is down 17 percent this year, trimming our gain to 37 percent. CHK is the second largest producer of natural gas and pioneered the use of fracking technology, a process of pumping liquids into shale under high pressure to recover oil liquids and natural gas that would not otherwise be recoverable. 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. Natural gas prices have recovered, the company has new leadership, and billions of assets have been sold to remedy the financial problems.

During the second quarter, CHK continued to sell non-core assets for which it received $675 million. In the second half of the year, CHK expects to receive $700 million in proceeds from various asset sales that have closed, or are underway. These asset sales are in line with the mission of focusing on profitable growth while reducing financial complexity and lowering overall leverage. Along these lines, CHK increased its drilling and capital expenditures by 55 percent from the first quarter.

As a result, Chesapeake's daily production during the quarter averaged 694,650 barrels of oil equivalent (BOE), a year-over-year increase of 13%, adjusted for asset sales.

CHK's more promising assets are located in the Utica Shale in Ohio, Pennsylvania, and West Virginia where fracking produced an increase in BOE of 34 percent over the previous quarter and 373 percent from the same quarter last year.

Fracking the Southern Marcellus Shale in Pennsylvania and West Virginia resulted in an increase of 67 percent of BOE year over year from one rig connected to nine wells. Chesapeake recently added a second rig.

Fracking the Northern Marcellus Shale in Pennsylvania produced an increase of 12 percent in BOE year over year. In addition, there was a 15 percent increase from CHK's Eagle Ford Shale in south Texas, one of CHK's largest producing areas.

With earnings projected to be $2.30 next year, CHK is still a good value. Morningstar's fair value estimate of CHK is $37 which is still substantially higher than the current stock price.

**Fidelity Select Natural Gas Fund (FSNGX)** is up 6.8 percent this year, extending our gain to 38 percent.

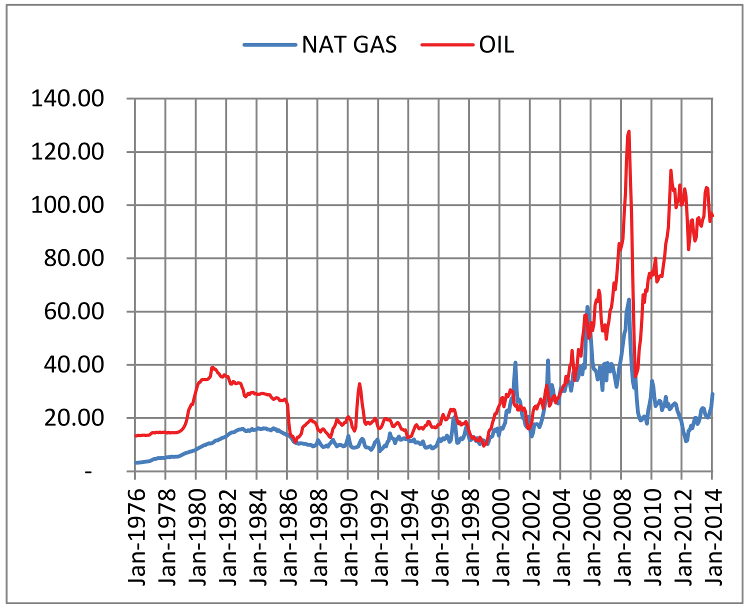
Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other sources of energy, which translates into an inexorably vibrant and expanding natural gas industry.

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 $4.00 for one million BTUs, 5.8 million BTUs will cost $23.20 (5.8x$4). So the same amount of energy is available for 23 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 to the right 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.

**The Cost of Energy Equivalents of Oil and Natural Gas**




**Freeport-McMoRan Copper & Gold (FCX)** was originally added to the portfolio last year at $30.42 per share. FCX is up 9.5 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.

The resumption of operations in its Grasberg mine, one of the largest copper and gold mines in the world, will increase gross revenues and lower overall production costs. The commencement of copper production at its newly expanded Morenci operation will also be adding to earnings.

FCX offers a very attractive dividend yield with excellent growth potential.

**Hambrecht & Quist Life Sciences Fund (HQL)** is up 13 percent this year, extending our profit to 62 percent. HQL is a closed-end fund which means that the price of the fund can vary from the value of the underlying net asset value (NAV) of the fund's holdings. Currently the price of HQL is close to a 5 percent discount to its NAV.

We have been recommending this Fund because the most explosive profits in the entire healthcare industry can be found in biotech companies. Sales of the top drugs now come from biotechnology origin, a drastic change from 10 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 largest holding is Gilead Sciences, the inventor of *Sovaldi*, a drug that cures Hepatitis C, and promises to be the most successful drug ever. Gilead also has promising remedies for HIV and AIDS, along with products for cardiovascular needs, macular degeneration, systic fibrosis, and influenza.

Other HQL's holdings include Celgene, Biomarin Pharmaceuticals, Pharmacyclic, Biogen Idec, Medivation, Amgen, Regeneron Pharmaceutical, Puma Biotechnology, and Sangamo BioSciences, all of which have promising products and treatments for a wide variety of dreadful diseases.

**Hersha Hospitality (HT)** is up 15 percent since our recommendation in December 2013. Our principal reason for continuing to recommend HT is because the stock is selling at a significant discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the economic recovery.

In addition, many of its major properties have been undergoing renovations, and the full income potential has yet to be realized.

Based on the most recent second quarter results reported in August, we value HT's NAV at $7.86 per share, an increase from $7.33 in the first quarter. The increase was primarily due to the addition of two properties during the second quarter. We expect to see further increases of NAV as income from new acquisitions are realized along with increased income from completed renovations.

In September, as a result of the cash flow growth so far from the ramp-up of strategic acquisitions and renovations, Hersha increased its quarterly dividend from $0.06 per share to $0.07 per share.

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 3.4 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 has out-performed the Energy Equity Index resoundingly.

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.

**NCR Corp (NCR),** formerly known as National Cash Register, was initially recommended in our August 14, 2014, e-mail update. It is essentially unchanged since then.

The stock declined 25 percent during the previous 12 months prior to our recommendation, and looks like it found its bottom. NCR makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

The consensus is that NCR will earn from $3.00 to $3.10 per share this year, so the stock is currently close to 11 times earnings which is a steep discount to the market as measured by the 16+ price-to-earnings ratio (P/E) on the S&P 500.

NCR is cheap because rapid earnings growth came to a halt beginning in 2013, causing the stock to slide. The reason for the slowdown in earnings was because NCR increased its debt load to make two significant purchases -- Retalix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth but have now started to add to earnings and have pushed NCR much farther along its path from a hardware provider to more of a software and services provider where profit margins are substantially higher.

Earnings next year are expected to climb to $3.50 a share. At 15 times earnings, the stock would trade above $52.

Another catalyst for growth comes from the fact that approximately 90 percent of ATMs in the US still run on Windows XP which Microsoft just stopped supporting. That will translate into increased demand for NCR's ATMs.

In September, NCR announced "Wayfinding", an application for mobile devices (iOS and Android), kiosks, a web site that helps passengers easily locate products and navigate through airports using multi-lingual touchscreens for gates, flights, restaurants, shopping, and rest rooms.

NCR does not pay a dividend because it is using its capital for growth. At this price we believe it is a solid investment with limited downside risk and very good profit potential.

**Pfizer (PFE)** is down 2.6 percent this year, trimming our profit to 89 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, and *Xeljanz* for inhibiting the progression of rheumatoid arthritis. Pfizer's top selling drugs include *Lyrica* (for pain and fibromyalgia), and *Prevnar* vaccines (for pneumonia and other infections).

In September, Pfizer attempted another "tax inversion" acquisition of Actavis to lower its US corporate tax expense (purchasing a foreign corporation and moving the domicile of the combined company to the acquired company's country where the corporate tax rate is lower). However, negotiations stopped as the Treasury Department announced rules to deter tax inversions.

Pfizer is repurchasing $5 billion of its own common stock after purchasing $16.3 billion in 2013.

PFE is a good value with promising growth from a wide array of drugs and treatments. Its dividend is close to 3.5 percent.

**Retail Opportunities Investment Corp (ROIC)** is up 3.3 percent this year, extending our profit to 51 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. So far this year, ROIC has purchased $358 million of shopping centers, following $368 million of acquisitions during 2013. 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 9.8 percent this year, extending our profit to 101 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 along with its strong cash flow, gives SYK multiple avenues for continued growth through acquisitions.

In August, SYK completed the acquisition of Small Bone Innovations (SBI) which has products for trauma and diseases in small bones and joints including ankles, fingers, wrists, and elbows. Its three-piece "STAR" ankle replacement system is available in over 40 countries, strengthening SYK's product offering. This adds to other recent acquisitions including Pivot Medical which has a platform of arthroscopic implants to efficiently access the hip with minimal incision. Berchtold Holding was also acquired 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 up 0.9 percent this year, extending our profit to 44 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. Ninety-nine percent of Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In September, SYMC announced the appointment of Michael Brown as the company's CEO. Mr. Brown has been serving as interim president and CEO since March and has made significant improvements to Symantec's operating and financial performance, as well as working with the Board and the management team to develop a strategic plan based on focused investment and innovation in key areas of high customer need.

Since becoming SYMC's interim president, Mr. Brown has introduced new revenue and efficiency initiatives, which have contributed to increased revenue and put SYMC in position for growth.

Before joining Symantec's board following the company's merger with VERITAS Software in July 2005, he served as chairman and CEO of Quantum Corporation and grew that company's revenues from $3 to $6 billion.

SYMC's below-average market price/earnings multiple makes it a good value, and 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.

**Tetra Tech (TTEK)** is down 9.1 percent this year, trimming our profit to 65 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 is in the process of changing its Remediation and Construction Management ("RCM") segment by exiting its construction business in non-core construction markets which contributed close to 50 percent of the RCM total revenue but have not added significantly to cash flow. TTEK will retain and focus on its more profitable and reliable businesses in environmental remediation, pipeline, solid waste and utilities. These changes are bound to bolster both margin and cash flow.

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** have a similar approach to ours because management is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. Specifically, 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).

An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the Funds they manage.

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 10.6 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.

During the third quarter, TVRVX sold five positions that management concluded became over-valued and invested the proceeds into companies tied to the US residential markets including some existing holdings and two new positions. One new position was in Realogy common stock, the preeminent and most integrated provider of residential real estate services in the US. The stock declined 20 percent and gave TVRVX an attractive buying opportunity. With the home sales at an all-time low as a percentage of inventory, the embedded earnings power is substantial. The company also has a $2.1 billion tax loss carry-forward that will minimize future taxes and increase cash flow.

The other new position was in Zions common stock, a bank holding company with eight banks controlling $45 billion of deposits in the Western region of the US. Zions has been trading at a discount to its peers and its book value because it had a significant share of its capital invested in collateralized debt obligations (CDOs), which caused Zions to fail a Federal Reserve stress test. However, Zions has reduced the CDO portfolio and completed a $550 equity offering, which has enabled Zions to pass the Fed's stress test. Zions is once again considered to be a well- capitalized bank with good growth prospects and a desirable acquisition candidate for a larger bank.

As an example of management's attention to value, the Fund's positon was increased in Westfield common stock during the quarter, ahead of the spin-off of its Australian portfolio of world-class malls into an Australian REIT. TVRVX elected to sell the REIT because its price exceeded its NAV. However, the position in Westfield common was retained because it has an opportunity to substantially increase its NAV as it delivers major development and expansion projects, including the retail mall at the World Trade Center site in New York City, as well as the expansion of the Westfield Mall in West London, a development in Milan, and the continued development of the Century City sub-market of Los Angeles.

TVRVX also increased its holding of Cheung Kong common stock, a Hong Kong based holding company with substantial real estate investments. Similar to other holdings such as Weyerhaeuser and Westfield, Cheung Kong has transformed its business model by selling down exposure to yield-oriented assets in Asia and reinvesting proceeds into real assets in Europe on an opportunistic basis.

The **Third Avenue Small-Cap Value Investor Fund (TVSVX)** is down 5 percent since we introduced it earlier this year. This fund 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.

In making decisions regarding a particular company, management evaluates the entire business enterprise, assesses the assets, and ascertains the NAV. From there, a credit profile is created to ensure that the company has the ability to meet its obligations, take advantage of investment opportunities, and survive financial storms. Important but secondary are earnings trends.

During the third quarter, management added four new positions to the portfolio. It also disposed of 8 holdings. Although these 8 were strong contributors to growth, their prices had risen above their respective net asset values.

**Transocean (RIG)** was introduced to our portfolio in

June because of its low valuation and high yield, which we continue to view as a buying opportunity. While on-land fracking and other new techniques have added to supplies, the majority of oil still comes from deep-water drilling, and RIG is a premier provider of those platforms to the world's major oil companies.

RIG has had a rough ride this year. It has fallen below 10 times 2014 projected earnings. Even forgoing the 15 percent foreign tax withholding, the net dividend is above 8 percent.

Although weak oil prices have made it difficult for the drilling industry, RIG has fared reasonably well under the circumstances and much better than the stock price would imply. Its backlog of contracts should keep revenue flowing. Meanwhile it has reduced costs substantially and is continuing to do so.

In addition, it is using proceeds from aggressively selling its older platforms in recent years to build new ones, upgrading its fleet portfolio and maintaining RIG's competitive edge.

RIG is also forming master limited partnerships (MLPs) which will purchase some of its assets and give RIG a cash infusion to bolster its balance sheet. The first MLP was in July, capitalized with $350 million to purchase a 51% interest in three assets located in the Gulf of Mexico; two ultra-deepwater drill ships which are leased to Chevron and one semi-submersible rig leased to British Petroleum (BP). The next MLP, called the Caledonia Offshore Drilling Company, will purchase 8 of its rigs operating in the North Sea.

The creation of these MLPs is highly beneficial to Transocean because it enables the company to sell assets at higher prices than could be realized in the open market, while still maintaining control of these assets.

In September, a cloud of litigation risk was removed by a decision of the US District Court for the Eastern District of Louisiana by ruling that BP's contractual agreement to indemnify Transocean for compensatory damages is valid and enforceable regarding the 2010 accident in the Gulf of Mexico. The Court also ruled that Transocean was not grossly negligent which means that the company is not liable for punitive damages. This ruling ratified the industry-standard allocation of liability between drilling contractors and the owners and operators of oil wells.

We expect a substantial recovery over the longer run from the depressed stock price.

**USAA Precious Metals & Minerals Fund (USAGX)** is up 5.4 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.

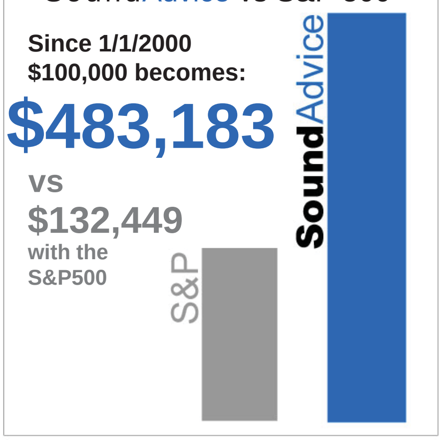
This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is the top-performing fund, and has constantly out-performed precious metal equities for ten years.

**The SoundAdvice Portfolio**

**25.6%** Since Jan 1, 2013

**55%** Average Profit in Current Positions

SoundAdvice vs S&P 500




**Xerox (XRX)** is up 8.2 percent this year, extending our profit to 59 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). The strongest growth is coming from the expansion into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

Since XRX acquired Affiliated Computer Services in 2010, its services segment has been the driving force of growth which now accounts for 57% of total revenue. The company's renewal rate for its service contracts is running at 92 percent, bolstered by a focus on health care services provided by government agencies. As Obamacare expands, so will XRX's services.

XRX's ongoing transformation is reminiscent of IBM's evolution that began in the 1990s from purely a hardware company to one also offering an array of services to its clients. As a result, IBM's revenues and growth accelerated for many years.

Growth is also promising through innovations. XRX has filed for more than 500 patents annually since 2008. Among the most promising is for printable electronic circuitry. When used in conjunction with 3 dimensional printing, the potential exists for the creation of all kinds of "smart" products. XRX is also working on printable batteries.

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 | $ 17.50 | 4.34% | $ 19.50 | BUY |
| Hersha Hospitality Trust | HT | NYSE | $ 6.25 | 3.84% | $ 7.86 | BUY |
| Retail Opportunity Investment Corp | ROIC | NASDAQ | $ 14.75 | 4.07% | $ 17.00 | BUY |
| Third Avenue Real Estate Value Investor | TVRVX | 800-443-1021 | $ 30.71 | 2.15% | $ 33.00 | BUY |
| **Diversified Growth** | | | | | | |
| NCR Corp | NCR | NYSE | $ 32.19 | 0.00% | $ 35.00 | BUY |
| Pfizer | PFE | NYSE | $ 29.06 | 3.58% | $ 32.00 | BUY |
| Stryker Corp. | SYK | NYSE | $ 81.74 | 1.30% | $ 87.00 | BUY |
| Third Avenue Small-Cap Value Investor Fund | TVSVX | 800-443-1021 | $ 26.41 | 0.00% | $ 32.00 | BUY |
| Xerox | XRX | NYSE | $ 12.98 | 1.93% | $ 14.50 | BUY |
| **Energy/Natural Resources** | | | | | | |
| Agrium | AGU | NYSE | $ 85.80 | 2.97% | $ 100.00 | BUY |
| Chesapeake Energy Corp | CHK | NYSE | $ 22.23 | 1.57% | $ 25.00 | BUY |
| Fidelity Select Nat. Gas Fund | FSNGX | 800-544-8888 | $ 40.29 | 0.82% | $ 48.00 | BUY |
| Freeport-McMoRan | FCX | NYSE | $ 32.07 | 3.90% | $ 40.00 | BUY |
| ICON Energy Fund Class S | ICENX | 800-828-4881 | $ 21.88 | 3.38% | $ 27.00 | BUY |
| Tetra Tech | TTEK | NASDAQ | $ 25.28 | 1.11% | $ 27.50 | BUY |
| Transocean | RIG | NYSE | $ 31.58 | 8.07% | $ 45.00 | BUY |
| USAA Precious Metals & Minerals | USAGX | 800-862-6909 | $ 13.75 | 0.15% | $ 18.00 | BUY |
| **Aggressive Growth** | | | | | | |
| Boston Scientific | BSX | NYSE | $ 11.85 | 0.00% | $ 14.00 | BUY |
| ETF - Direxion Daily 20+ Yr Bear 3X | TMV | NYSE | $ 41.35 | 0.00% | $ 55.00 | BUY |
| ETF - ProShares Short 20+ Year Trsry | TBF | NYSE | $ 27.44 | 0.00% | $ 30.00 | BUY |
| ETF - ProShares UltraShort 20+ Year Trsry | TBT | NYSE | $ 55.04 | 0.00% | $ 65.00 | BUY |
| H&Q Life Sciences Fund | HQL | NYSE | $ 21.81 | 0.00% | $ 25.00 | BUY |
| Symantec | SYMC | NASDAQ | $ 23.35 | 2.57% | $ 25.00 | BUY |

**This table has live prices, charts & buy limits on our website:** http://www.soundadvice-newsletter.com/members

**Notes to the table:**
Prices are as of 10/2/2014. 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 below our “Buy” limit.

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 $11.4 million in stocks and to $1.49 million in houses.

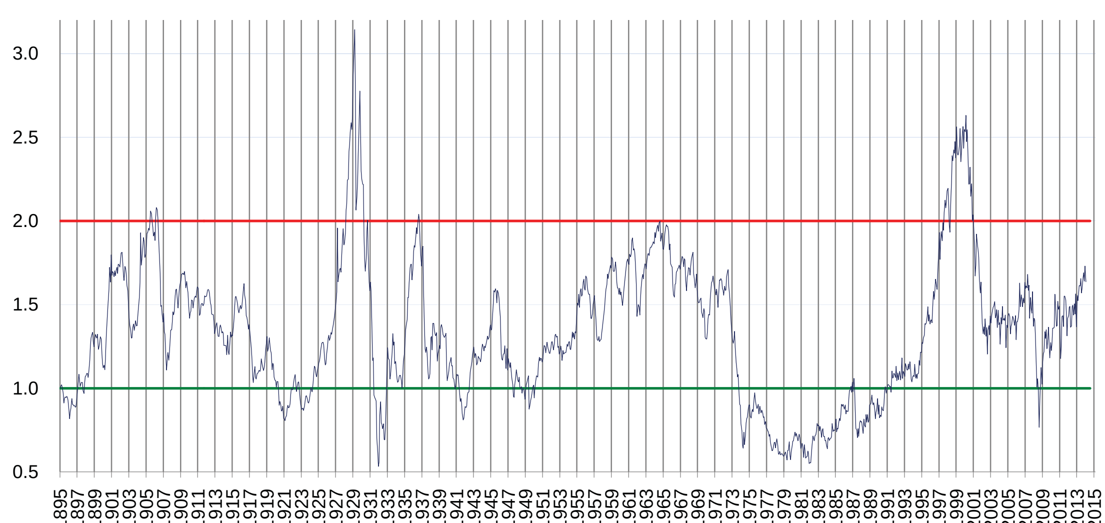
But though an investment beginning with $25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made $456 million, or 39.7 times more money—the 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 1.67. 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 renew 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 33.3 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 which tells us that the economy has become strong enough to push up inflation and long-term interest rates along with bond yields. It registered 66.7 percent in August.

## 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 2.0 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% | | 2.0% |

See ***The Science of Making Money in Turbulent Markets*** for a complete explanation of the **Sound**Advice 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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