



## What a Difference a Day Makes



The *Sound Advice* portfolio is up 10.98 percent so far this year as compared to 6.3 percent for the S&P 500. If we look back to the beginning of last year, the portfolio is up 41.4 percent as compared to 20.5 percent for the S&P500. We have an average gain of 59.9 percent based on the prices at which each stock, ETF, or mutual fund was originally recommended.

We often get the question "Which positions in your model portfolio are your favorites?" The answer is they are like our children – we love them all the same. If you are buying all of them, we recommend an equal amount in each one. If that is not practical, we have divided up the portfolio into three sectors to better match your investment objective. (See the table on page 7). Perhaps your background and experience makes you more familiar with some more than others, and you can choose those.

For tracking our performance, we use an equal amount of money in each position. If they are recommended again, we add the same amount of money again. Because each has appreciated over time at different rates, and some were recommended more than once, they do not have equal weighting. However, most of the time that doesn't make a significant difference.

If we rebalance the portfolio at the beginning of the year by assuming an equal amount of money in each position, the portfolio is up 11.02 percent so far, as opposed to 10.98 percent as if you had made each investment at the time we recommended it.

**-Gray Emerson Cardiff**

On February 25<sup>th</sup>, **CommonWealth REIT (CWH)** announced that it planned to issue up to 31 million shares to pay off some of its debt, and the stock dropped to under \$16 a share. On the following day, activist investors challenged the planned offering and CWH jumped over 50 percent, closing at \$24.40.

The offering first drew the ire of Keith Meister, hedge-fund manager of Corvex Management, who demanded the board cease the offering, claiming that management incentives do not mesh with the creation of shareholder value.

Joining the challenge was Related Fund Management, part of the Related Companies, founded by billionaire Stephen Ross. These two activists had purchased a stake of 9.8 percent of CWH outstanding shares.

Luxor Capital, CommonWealth's second-largest shareholder with 8 percent of the outstanding shares (behind Vanguard) also joined the challenge supporting the view that there is "a substantial discount" between the company's value and its stock price. They charge that the reason for the valuation gap is "conflicted management and persistently poor asset allocation decisions by the Board of Trustees," including the recently-announced share offering.

These activists contend that poor corporate governance of CWH, along with excess management fees that are not based on performance, have depressed the price of the stock. They are threatening a proxy fight to replace members of the board (which requires a two-thirds vote) or the entire board if necessary, including President Adam Portnoy and his father, Chairman Barry Portnoy.

The activists said they would even be willing to buy the company's assets at a premium to its current market price. The two funds offered to buy all of CWH's common stock for \$25 per share, a 58% premium to the previous day's closing price of \$15.85 per share. They project that CWH real estate assets are worth about \$40 a share, and with better management, they expect CWH could hit a target share price of \$50.

On the following day, CWH management said it will be moving forward with the offering. The activists then filed a lawsuit in Maryland state court alleging that CommonWealth breached its fiduciary duties to shareholders. The suit also names the CommonWealth board and its external manager, REIT Management Research LLC, the majority of which is owned by the Portnoys.

We are rejoicing. We have been recommending this stock on the basis of its extreme discount to the underlying value of the real estate portfolio. We have been valuing the real estate conservatively by using a 9 percent capitalization rate, which translates the value of CWH's real estate net assets to \$31.52 a share based on the fourth quarter financials released on February 25<sup>th</sup>. However, capitalization rates are significantly lower today, in the vicinity of 7 percent. Using an 8 percent rate, for example, brings the value to \$41.36 per share. We have also contended that the reason the stock has been trading at such a deep discount was because of the poor corporate governance and the management fee structure, and that, until a few days ago, the discount was unrecognized by the market.

We are rejoicing because the discount now has the attention of Wall Street. We would also like to see the external management company removed, and replaced with a traditional "self-managed" REIT structure, with a staff of

officers and employees of CWH who are incentivized by the performance of the REIT. Not only would management costs be lower, management incentives would be more properly aligned, and the stock would trade with a better valuation to its real estate assets.

Even though the offering ignited the furor, we do not see the share offering as being a problematic strategy provided that the proceeds are used as promised to pay off a corresponding amount of debt, thereby leaving stockholder equity essentially unchanged.

In any case, it is hard to imagine that any stockholders are happy with the present management. The uprising is likely to have a ground swell of support.

### Fed Watch

On February 20, the Federal Reserve made the minutes public from its January 29-30 Federal Open Market Committee (FOMC) meeting. Several members said the central bank should be ready to vary the pace of their \$85 billion in monthly bond purchases amid a debate over the risks and benefits of further quantitative easing. A number of officials said that their evaluation of costs and benefits of the policy “might well lead the Committee to taper or end its purchases before it judged that a substantial improvement in the outlook for the labor market had occurred.”

The minutes said “many participants” expressed concern about “potential costs and risks arising from further asset purchases.” Several discussed “possible complications” that additional purchases could have as the Fed begins to exit the policy, a few mentioned inflation risks, and some mentioned risks to financial stability.

The officials “emphasized that the committee should be prepared to vary the pace of asset purchases, either in response to changes in the economic outlook or as its evaluation of the efficacy and costs of such purchases evolved.”

At their December meeting, Fed officials debated the date for ending their bond purchases, with officials “approximately evenly divided” between those favoring mid-2013 and those favoring a later end, according to minutes from the meeting. January’s minutes didn’t indicate a discussion of dates but more on the tactics and implications of the Federal Reserve’s “Exit”.

The FOMC said in a statement after its January meeting that “growth in economic activity paused in recent months, in large part because of weather-related disruptions and

other transitory factors.” The committee predicted the expansion will proceed at a “moderate pace.”

### Underlying Strength

Despite a rough winter in most areas of the country, signed contracts to buy existing homes jumped 4.5 percent in January. These are pending sales which are a leading indicator for the home market because these are future sales for the next few months.

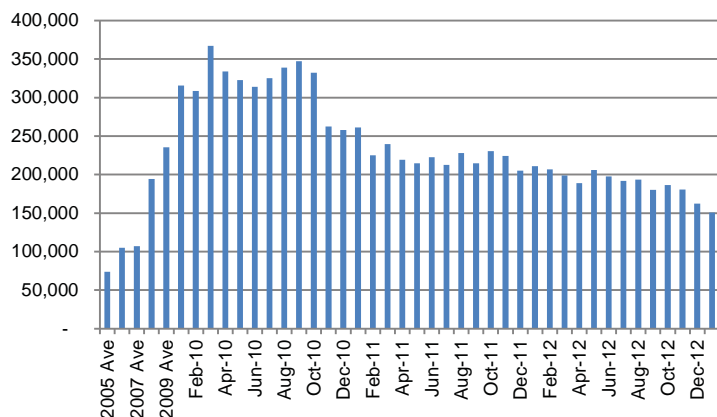
“Over the near term, rising contract activity means higher home sales... home prices are projected to rise more strongly because of inventory shortages,” wrote Lawrence Yun, chief economist for the National Association of Realtors. Home builders broke ground in January on 613,000 houses, the most in four years.

The National Association of Realtors says that pending sales would have been higher if it were not for shortages in supply. Close to half of home sales last year were distressed properties. Except for a few areas in Florida and southern California, the inventory of foreclosed homes has essentially dried up.

Statistics from the extensive database of Realty Trac in Irvine, California, [www.realtytrac.com](http://www.realtytrac.com) confirms the significant drop in foreclosures. The following chart shows US foreclosure rates. In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the 2010 fourth quarter. At first, the decline was due largely to a freeze

US Foreclosure Rates - Monthly Averages



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in foreclosures by several major lenders. The downtrend continued as Federal and state foreclosure prevention efforts allowed distressed homeowners to stave off foreclosures. Foreclosure rates have been declining substantially since mid-2012 – down 27 percent.

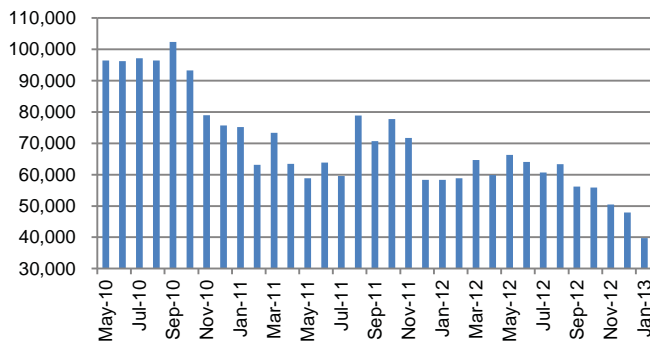
**Dissecting the Foreclosure Process**

The foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures is actually the aggregate of the number of properties in each of these three stages.

We can get an early glimpse of a change in trends by focusing on changes in the first step of the foreclosure process: new default filings. After all, a significant change in the first step of the foreclosure process must ultimately lead to a significant change in the aggregate number.

The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month.

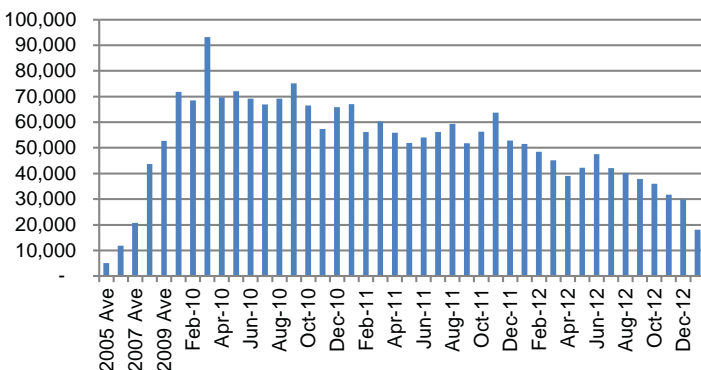
**US New Default Notices**



In October 2010 they began declining but remained stubbornly high through mid-2012. However, since then new default notices have dropped 40 percent.

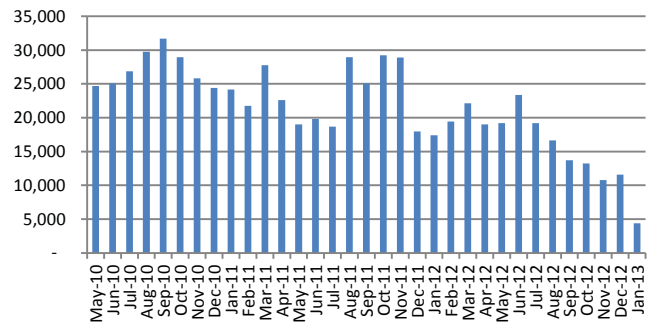
Until recently, one fourth of the nation's foreclosures have been in California. The following chart shows all stages of the foreclosure process in California (including auctions and bank repossessions).

**California Foreclosures - Monthly Averages**



In 2005, California foreclosures averaged 5,138 properties per month. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Foreclosure rates remained high in 2011 and began declining in 2012, and are now down 70 percent.

**California New Default Filings**



California's new default notices have dropped even more, by 80+ percent. See the chart.

We have seen all this before. It was back in the 1980s. After several years of loose and questionable lending practices, when the tide turned, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts.

A significant change in foreclosure rates was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began.

As the rising swell of home foreclosures that began in 2007 turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US economy. Indeed, the state of the nation's real estate markets and the economy has become one and the same. The real estate crash was at the heart of the financial crisis, and we cannot have a sustainable recovery in the economy without a recovery in real estate.

We need to keep in mind that while the Federal Reserve has complete control of short-term interest rates by setting the Federal funds rate, it does not have complete control over the bond market. That is because the bond market is far larger than the Federal Reserve's coffers, and is subject to powerful market forces. Long-term bond yields will start to increase as the economy gathers strength, even in the face of the Federal Reserve's bond buying. In addition, as with all markets, the bond market will anticipate events ahead of time, especially the Fed's withdrawal from its bond-buying program.

Our "No-Brainers", the reverse ETFs will benefit strongly from a rise in yields on long-term Treasury bonds. Long-term bond yields and the prices of our No-Brainers all advanced strongly after the fiscal cliff resolution. We said in last month's Issue (dated February 1) that the cloud

## The History of 30-Year Treasury Bond Yields



This graph shows the yields of 30-year Treasury bonds since 1977. As you can see, the recent lows are historic. Yields have been close to the recent lows only once before -- after the 2008-09 meltdown as systemic risks in the banking system fueled a capital flight to safety.

Source: Yahoo! Finance

of uncertainty over the “sequester” would undermine the strong advances, and long-term bond yields retraced about half of the increase. Our No-Brainer ETFs followed the path in accordance with the leverage they mirror. All are still higher since the beginning of the year:

The most responsive ETF, the **Direxion Daily 20 Plus Year Bear 3 Shares (TMV-NYSE)** which uses 3 to one leverage, is up 4.8 percent.

The **Proshares Ultrashort Lehman 20 Plus Year Treasury (TBT-NYSE)** which uses 2:1 leverage, is up 3.5 percent.

The **Proshares Short 20 Plus Year Treasury (TBF-NYSE)** which uses no leverage, is up 1.7 percent.

In the aftermath of any recession, bond yields and long-term interest rates always rise. It is as simple as that. As we have pointed out in recent issues, the rise in long-term Treasury bond yields does not have to be large to bring us exceptional profits. With a rise in yields to 4.75 percent, TMV should more than triple. TBT should more than double, and TBF should rise more than 50 percent.

From the chart above showing the history of long-term Treasury bond yields, we can see that 4.75 percent is still a historically low yield on long-term Treasury bonds. Gains could be considerably higher.

### Portfolio Updates

Here are updates on the rest of our recommendations in alphabetical order. The table on page 7 details buy limits and other information on each recommendation, and organizes them by investment objective.

**Agrium (AGU)** is up 3.2 percent this year, after climbing 48 percent in 2012. We have a profit of 765 percent. This is the largest farm products retailer in North America and a

wholesaler to the rest of the world.

Agrium’s production facilities are located almost entirely in western Canada, where the cost of natural gas, the primary feedstock for producing nitrate-based fertilizers, is cheaper than in other areas of North America. Competitors elsewhere have higher costs. Agrium also gives its customers a choice among different types of fertilizer depending on what market offers better value at any given time. That flexibility will also help Agrium outperform its main competitors,

AGU is close to 10 times earnings. This price earnings (P/E) ratio is below average and very low for a company with a history of growth and future growth prospects. Accordingly, AGU remains undervalued.

**AMN Healthcare (AHS)** is up 19 percent this year, extending our profit to 159 percent.

AMN Healthcare provides temporary healthcare staffing services to the healthcare industry, ranging from nurses to physicians. The rationale for buying AMN Healthcare was a two-fer. AHS is not just an opportunity to invest in healthcare, which is traditionally a non-cyclical industry, but it is also a chance to buy into a healthcare business that will benefit from a recovery in the economy.

We have a “Hold” on AHS because the stock has climbed to the point where the price is now close to 24 times 2013 earnings estimated at \$0.45 a share. This price/earnings ratio is at a hefty premium to the average of its peer group. We think this stock has gotten ahead of itself and recommend holding for now while waiting for a pull-back to invest more.

**Associated Estates Realty Corp (AEC)** is up 8.4 percent this year, extending our profit to 23 percent.

This is the most undervalued apartment REIT in the sector. The equity of its apartment portfolio translates into a stock

value of \$27 per share. So the stock is trading at a steep discount. It pays a nice yield as well.

Funds from Operations (FFO) for the fourth quarter were \$0.34 per common share compared with \$0.26 per common share for the fourth quarter of 2011, a 30.8% increase. Net operating income (NOI) for AEC's same community portfolio increased 7.9% over the same period, and physical occupancy increased to 96.0% from 95.2%.

**Boston Scientific (BSX)** is a classic turnaround story. It has had flat earnings but has a new CEO who is focused on growth. BSX's medical products are well suited for an aging population in the US as well as emerging markets around the world, especially in India, China, Brazil, and Russia. Emerging markets only accounted for 4 percent of revenue in 2012, so there is considerable room for growth.

Growth should be particularly strong from its Subcutaneous Implantable Defibrillator (S-ICD) which is implanted under the skin without touching the heart or blood vessels. BSX is also planning to roll out new products to treat severe asthma, hypertension, atrial fibrillation, and other conditions.

A brighter day lies ahead. Based on the depressed price of this stock, gains from the current low price should be substantial.

**CGM Real Estate Fund (CGMRX)** is up slightly this year, extending our profit to 57 percent. We believe that this fund is poised for considerably more gains ahead as the economy recovers.

Most of the time, above average investment returns can be earned in REITs. In 2012, US REITs outperformed the broader equity market. The Morgan Stanley Capital International (MSCI) Index of US REITs, a benchmark index that measures the performance of publicly traded equity US REITs, rose 17.77 percent during the year, exceeding the 16 percent delivered by the S&P 500 in an exceptional year. That superior performance was not just in 2012. Last year was the fourth year in a row the US REIT index beat the market. In February, the MSCI REIT index hit its highest level since May 2008.

Over the last ten years, investing in the S&P 500 stocks and reinvesting all of the dividends would have produced an annual return of 6.98 percent. By contrast, the MSCI Index of US REITs rose 11.58 percent annually on average.

Therefore, just finding a REIT mutual fund that matches the averages will likely bring you investment returns that are superior and more reliable than the stock market as a whole.

CGMRX has been the best performer -- by far -- over

the last ten years, furnishing an annual return of 19.17 percent. Investing \$10,000 in this fund grew into \$57,774. This fund's performance was head and shoulders above the MSCI Index of US REITs, as well as the performance turned in by all other real estate funds.

Unfortunately, CGMRX does not have an agreement with Fidelity and other brokerage firms. You will need to call the fund directly to invest at 800 343 5678.

**Chesapeake Energy (CHK)** is up 21 percent since we added it to the portfolio last year. It was cheap for three reasons: low natural gas prices, poor corporate governance, and a cash shortfall. There has been substantial progress on all of these aspects.

First, natural gas prices have climbed significantly since our recommendation. Secondly, Carl Icahn bought a stake in 2012, and has been instrumental in removing the founder,

Aubrey McClendon, as chairman of the board and replacing several other board members. Then on January 30th, McClendon suddenly retired (at age 53) which caused the stock to jump. Icahn's activity is putting pressure on the board to maximize shareholder value. And finally, CHK has sold \$11.6 billion of \$14 billion in targeted divestments to straighten out its cash squeeze.

CHK's remaining natural gas and oil assets are extensive and offer a large upside. Morningstar's fair value estimate is still \$26 a share.

On February 26, CHK and Sinopec International Petroleum Exploration and Production Corporation (Sinopec) initiated an agreement whereby Sinopec will purchase a 50% undivided interest in 850,000 of Chesapeake's net oil and natural gas leasehold acres in the Mississippi Lime play in northern

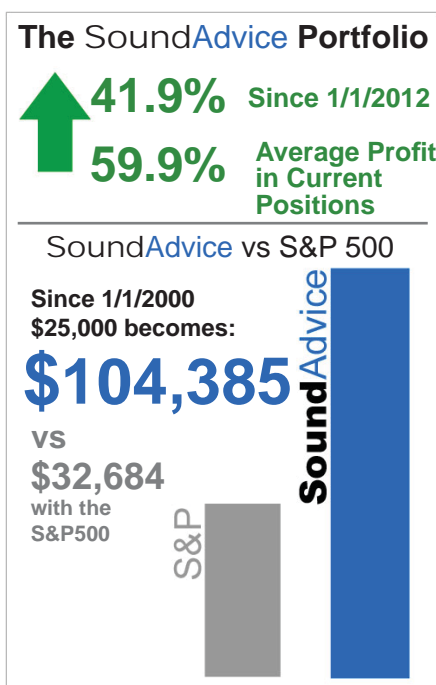
Oklahoma. The total consideration for the transaction will be \$1.02 billion in cash, of which approximately 93% will be received upon closing.

Sinopec Corp. is one of the largest integrated energy and chemical company in China. Having a partner in China gives CHK leverage in that market.

**Comcast (CMCSA)** is up 7.5 percent this year, after climbing 57 percent last year, extending our profit to 122 percent.

On February 13, CMCSA announced that it was buying the remaining 49 percent of NBC Universal from GE for \$16.7 billion. The stock jumped over 6% on the news and hit a new high. It has since pulled back close to our upper buy limit.

NBC Universal operates 30 news and entertainment cable networks (including the CNBC news channel) which



offer a mix of revenues and operating leverage to CMCSA, and should enable it to be even more competitive with its peers.

**Fidelity Select Natural Gas Fund (FSNGX)** is the only mutual fund that concentrates on the natural gas industry. It is one of Fidelity's stable of tightly focused sector funds.

FSNGX is a diversified play on the gap between the energy equivalents of oil and natural gas. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. So if a barrel of oil is say, \$100, that is the cost of 5.8 million BTUs of energy.

On the other hand, the market price for natural gas is close to \$3.00 for one million BTUs. To buy 5.8 million BTUs will cost \$17.40 ( $5.8 \times \$3.00$ ). So the same amount of energy is available for approximately 17.40 cents on the dollar -- if it is in the form of natural gas.

As the chart shows, this 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. This stands to reason. After all, energy is energy, and it should cost approximately the same regardless of the form in which it comes. However, that is not the case today. Note the current yawning gap between the costs of these two forms of equivalent amounts of energy. For 5.8 million BTUs, it costs approximately \$100 if it is in the form of oil, but only \$17.40 in the form of natural gas.

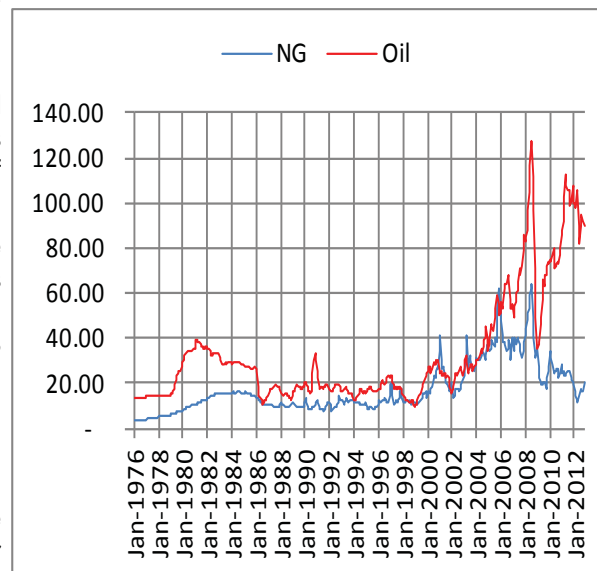
The US is self-sufficient in natural gas with only 9 percent imported from Canada. At 17.4 cents on the dollar versus oil, natural gas is bound to have a growing role in America's energy needs as well as independence from importing oil.

This fund is well positioned to benefit from an expanding natural gas industry.

**Hambrecht & Quist Life Sciences Fund (HQL)** is up 8.9 percent this year, extending our profit to 69 percent. The most explosive profits in the entire healthcare industry can be found here in biotech companies. This is a volatile sector, so diversification is crucial. HQL is a superior way to gain exposure to biotech on a diversified basis.

The climb in the price of HQL has brought the price/earnings (P/E) ratio of the underlying portfolio to 25. Although these are typically young promising companies which tend to carry high multiples, we are not anxious to chase a P/E of 25. Accordingly, we recommend accumulating shares on weakness.

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



**Leucadia (LUK)** is up 12.4 percent this year, leaving us with a 30.7 percent profit. This is a holding company with a portfolio in excess of \$9 billion of assets in beef processing, manufacturing, gaming entertainment, real estate activities, medical product development, and winery operations.

Its two principals, Ian Cumming and Joseph Steinberg, have been compared to Warren Buffett in their success at identifying lucrative investments that can be purchased substantially below their intrinsic value. In fact, Buffett continues to team up with the Leucadia team on joint venture investments. Several holdings

are directly partnered with Warren Buffett.

Skillful investing has produced double digit growth rates in its assets since 1979. After a bad year in 2008, assets have since grown by 150 percent according to Morningstar. The nature of their most recent investments in start-up biotech and energy companies offer a very large profit potential while affording relatively low risk. We think that LUK is valued well below the market prices of its disparate parts, with a very low debt-to-equity ratio. LUK's holdings currently translate into a P/E ratio of 11.9, substantially below the market averages. It remains undervalued.

**Masco (MAS)** was up 59 percent last year and up another 15.2 percent this year, extending our profit to 160 percent. MAS manufactures a wide range of products for home construction and remodeling --everything from kitchen cabinets and faucets to windows and paint.

We added MAS to the portfolio at \$7.49 after the shares got hammered during the recession. However, the share price has rocketed, bringing the price/earnings ratio to 29 times the 2013 earnings estimate of \$0.60 a share. This high price/earnings ratio is already anticipating a steep growth rate. The stock has pulled back recently. We continue to recommend waiting for more of a dip to accumulate more shares.

**Maxim Integrated Products (MXIM)** is up 6.9 percent this year, extending our profit to 61.4 percent. MXIM specializes in analog circuits which are essential for receiving and interpreting digital inputs. A cell phone is a perfect example. After receiving a digital signal, it must be transformed into an analog format so that we can hear it. MXIM also makes integrated power management chips (PMIC) for portable devices makers to extend battery lives.

The strong demand for cell phones has boosted MXIM's consumer business. Samsung's cell phones and tablets

Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$ 17.48	4.35%	\$ 18.00	BUY
CommonWealth REIT	CWH	NYSE	\$ 22.51	4.44%	\$ 25.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 12.92	4.33%	\$ 15.00	BUY
Diversified Growth						
CGM Realty Fund	CGMRX	800-343-5678	\$ 29.89	0.87%	\$ -	BUY
Comcast	CMCSA	NASDAQ	\$ 40.15	1.62%	\$ 39.00	HOLD
Leucadia National Corp.	LUK	NYSE	\$ 26.73	3.74%	\$ 28.00	BUY
Masco	MAS	NYSE	\$ 19.20	1.56%	\$ 16.00	HOLD
Paychex	PAYX	NASDAQ	\$ 33.17	3.86%	\$ 32.00	HOLD
Pfizer	PFE	NYSE	\$ 27.41	3.21%	\$ 28.00	BUY
Stryker Corp.	SYK	NYSE	\$ 63.66	1.34%	\$ 65.00	BUY
Xerox	XRX	NYSE	\$ 8.18	2.08%	\$ 10.00	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE/TSE	\$ 103.54	1.93%	\$ 120.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 20.14	1.74%	\$ 22.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 32.33	0.17%	\$ -	BUY
Tetra Tech	TTEK	NASDAQ	\$ 29.12	0.00%	\$ 30.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 22.50	0.36%	\$ -	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$ 13.74	0.00%	\$ 10.50	HOLD
Boston Scientific	BSX	NYSE	\$ 7.33	0.00%	\$ 8.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 56.84	0.00%	\$ -	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 29.88	0.00%	\$ -	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 65.67	0.00%	\$ -	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 15.79	6.84%	\$ 15.00	HOLD
Maxim Integrated	MXIM	NASDAQ	\$ 31.42	2.80%	\$ 33.00	BUY
Symantec	SYMC	NASDAQ	\$ 23.23	0.00%	\$ 24.00	BUY
Tellabs	TLAB	NASDAQ	\$ 2.04	3.92%	\$ 3.00	BUY

Prices are as of 2/27/2013. See our website for live pricing and buy limits.

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

Yields on funds do not include distributions of capital gains. Note that all fund distributions fluctuate annually.

are now contributing to 40 percent of MXIM's revenues and 30 percent of earnings. While the importance of Samsung is growing, MXIM is starting to sell integrated power management chips to other smartphone manufacturers who are aiming for growth in lower-priced handsets in emerging markets.

MXIM is in excellent financial health with \$1.0 billion of cash and plenty of cash flow to support operations. The investment and resources necessary to develop MXIM's high-performance analog chips takes years to develop which is an entry barrier for new competition. Once developed, these chips have long and profitable product lives.

**Paychex (PAYX)** is up 6.7 percent this year, extending our profit to 23.6 percent. PAYX is the second-largest provider

of payroll services to small to medium sized companies serving a total of approximately 567,000 payroll clients. Accordingly, its revenues and earnings directly mirror the employment situation.

The balance sheet is pristine with no long-term debt exposure. There is further growth ahead with a recovery in the economy. Morningstar's fair value estimate is \$38 per share.

PAYX recently increased its dividend (close to 4 percent) and announced a share buy-back program of \$350 million of the common stock through May 31, 2014.

The price/earnings ratio is currently close to 20 based on 2013 earnings estimated at \$1.60. While we are still comfortable at this price, we would recommend not chasing it higher.

**Pfizer (PFE)** is up 9.3 percent this year, extending our profit to 63.7 percent. Pfizer is the world's largest pharmaceutical firm, with annual sales near \$60 billion. Pfizer's large size gives it economy of scale and the resources to finance the research and development of new drugs. It has more than 80 drugs in the development stage and 90 in the discovery stage.

PFE has an extensive sales force to market its products in nations where growth and increasing wealth is strong, including Brazil, Russia, India, China, and Turkey, and PFE has devoted the resources to arm its sales force with plenty of data for marketing.

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. Pfizer is now poised to launch several blockbusters in cancer, heart disease, and immunology.

**Retail Opportunities Investment Corp (ROIC)** is essentially unchanged this year, leaving our profit at 21 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. It is a simple model: buy distressed retail properties with high-quality demographics, refurbish them, and then lease them at a premium. As new properties are added, along with tenant upgrades, FFO should continue to rise, along with the dividend, and push the price of this REIT upward.

The recently-reported fourth-quarter funds from operations (FFO) showed continued improvement, rising to \$8.5 million from \$7.5 million one year ago, an increase of 13.3 percent. On a per-share basis, FFO increased to \$0.15.

**Stryker (SYK)** is up 16.1 percent so far this year, extending our profit to 89.9 percent. SYK is best known for its orthopedic devices: 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.

Stryker's cash-rich balance sheet (with over \$2 billion in net cash) along with very little debt, and robust cash flow, gives SYK multiple avenues for growth through mergers and acquisitions. Management has been buying back shares and has steadily increased its dividend.

Reconstructive implants account for 45 percent of SYK's revenues, and more profits are assured by accelerating demand for joint replacements on aging baby boomers. As life expectancies continue to increase, and obesity trends continue, more and more hip, knee, and spinal procedures will be needed.

The Patient Protection and Affordable Care Act (PPACA) or Obamacare, aims at giving every US citizen health care insurance by 2014. That means new revenue streams for the Healthcare companies.

SYK recently agreed to acquire Hong Kong's Trauson Holdings which is aimed at increasing sales in China. Emerging markets currently contribute only 6% to SYK's overall sales. This acquisition gives SYK new avenues for growth.

**Symantec (SYMC)** is up 23.4 percent this year, extending our profit to 39 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its flagship brand, Norton. SYMC recently announced "Norton Zone" which allows users to safely access, sync and share photos, videos and documents from any of their PC, Mac, Android, or iPhones and iPads. SYMC has a large base of customers that provide recurring revenues of approximately 85 percent of total revenue, and growth is assured from the expanding use in cloud computing along with the commensurate need for security software.

Until 2012, the company has suffered from operational inefficiency and lack of direction. In July, 2012, Steve Bennett was hired as the new CEO. Bennett had a successful 23-year career at General Electric and a 7-year role as the CEO at Intuit. Bennett was brought in to streamline operations and give stronger direction.

On February 21, 2013, SYMC signed an agreement with Giesecke & Devrient (G&D), a German global leader in mobile security, to collaborate on the development of protected security applications on smartphones and tablets. The agreement avails SYMC to G&D's highly secure Trusted Execution Environment (TEE), and Symantec plans to update its mobile applications to provide an unprecedented level of security for Symantec's mobile security apps.

**Tellabs (TLAB)** designs and manufactures hardware for the telecommunications industry, which in a world of exploding demand for wireless communications should be a bonanza of a business. However, Tellabs has been slow to move its product lines as telecom service migrates into wireless.

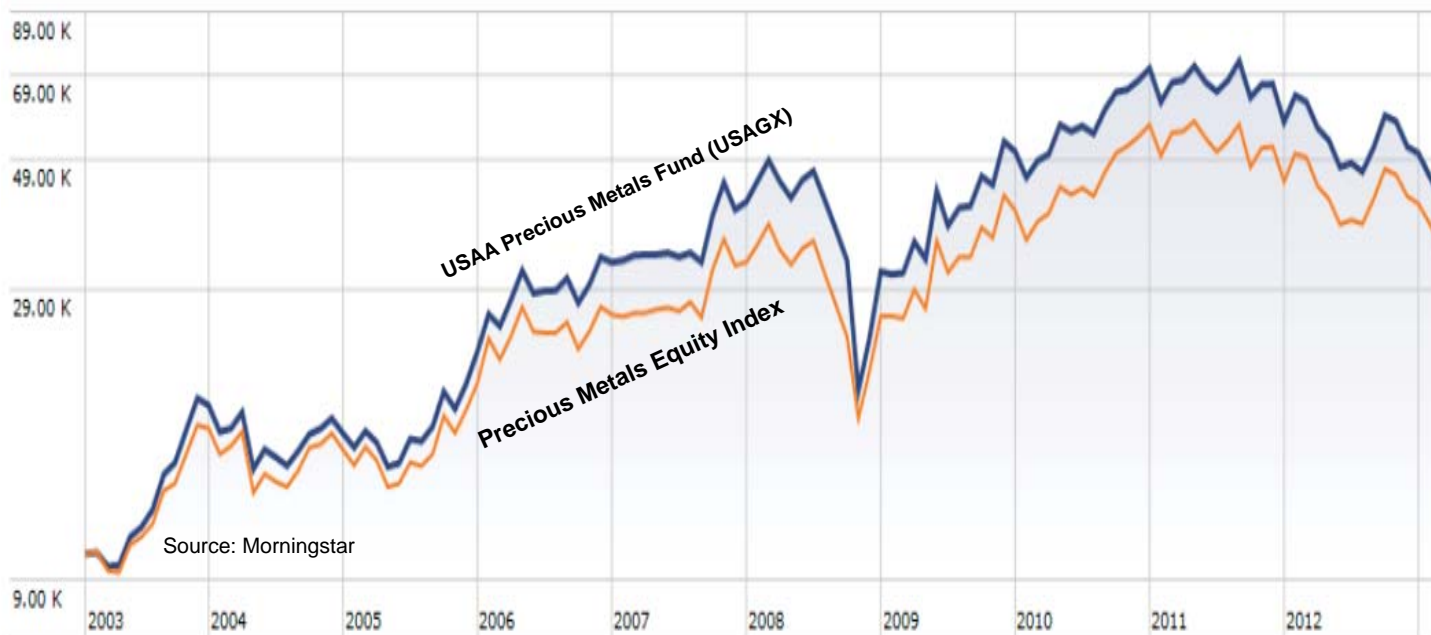
Now that the explosion of smart phones, tablet computers and wireless communication is testing the limits of telecom infrastructure, Tellabs should be able to gain a significant portion of that market. We think there is very little downside risk and nothing but upside.

The company has current (liquid) net assets of \$2.77 per share. Adding in its other assets, including properties and equipment (less depreciation), the net assets total \$3.11 per share. (In our calculation, we have excluded paper asset entries that are held on the Company's balance sheet which include Goodwill and Intangible assets amounting to \$.035 per share.) At the current stock price, we are buying the company's current net assets at a discount, and at a larger discount to all of its assets.

The company plans to buy back up to \$224.6 million of TLAB shares which will reduce the float by 20 percent.

**Tetra Tech (TTEK)** was up 22 percent in 2012 and is up 8

## Growth of \$10,000 in USAGX



percent so far this year, extending our profit to 85 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet.

TTEK currently has a record backlog of work totaling \$2.2 billion. Recent large contracts include technical support for the U.S. Environmental Protection Agency (EPA) to monitor water quality conditions. Other recent contracts include remediating NASA's Kennedy Space Center and Cape Canaveral Air Force Station, along with environmental remediation services at US Navy, Marine Corps, and other Department of Defense locations primarily in California and the southwestern United States.

The greatest growth potential lies outside the United States in China and India, where environmental concerns have been at best an afterthought. Only now are these governments starting to recognize the consequences. As these and other governments around the world make this a priority, Tetra Tech should be a prime beneficiary.

**USAA Precious Metals & Minerals Fund (USAGX)** was down 13 percent last year and is down another 16.1 percent this year.

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. Take a look at the chart above.

The top line (blue) shows the growth of \$10,000 invested in USAGX over the last ten years. Even after the poor markets and declines of precious metals, USAGX still provided an annualized return of 15.29 percent. The orange line shows the index of precious metals equities.

When the economy gets more traction, USAGX will benefit from the Federal Reserve's monetary stimulus programs which have been printing money to make massive purchases of Treasuries and mortgage-backed securities. All these extra dollars will raise inflationary expectations and cause the value of US currency to continue declining. Precious metals will be a direct beneficiary.

**Xerox (XRX)** has climbed 20 percent this year as Wall Street begins to see growth prospects again. In February, XRX declared a 35 percent increase in the company's quarterly cash dividend to 5.75 cents per share.

Although XRX is still focusing on the high end of the color printing market which still rewards technological improvements, this company is no longer just a copier maker. XRX has been transforming from a seller of printers and copiers to a company providing services on those machines. XRX is also adding business process outsourcing and information technology (IT) outsourcing. The revenue from services is more profitable and less cyclical and now accounts for half of XRX's revenues.

With sales approaching \$23 billion, XRX is the world's leading company for business process and document management.

XRX is expected to post earnings close to \$1.00 per share this year. The current stock price is less than 9 times earnings, which is incredibly low for a company with growth prospects. Any kind of recovery will bring a high capital gain. Morningstar's fair value estimate of the stock is currently \$11 per share.

## 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 \$8,833,529 in stocks and to \$1,328,723 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 \$350,669,053, 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 SoundAdvice Risk Indicator is 1.50. This reading reveals that stock prices are close to 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 SoundAdvice 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 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.

**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. This index hit 100% in March 2012 (reported in April - very close to the peak of the market) telling us to move to a cautious approach.

Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 100 percent.

Each month we project into future months the current readings for our hand-picked individual leading economic indicators that go into our Diffusion Index of Leading Indicators. We do this to see if a zero reading will be recorded assuming the readings stayed the same. However, due to significant increases in all of the leading indicators, we will not see a new signal (zero reading) in the months ahead unless the economy shows significant weakness.

### 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 declined an average of 0.5 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%		-0.5%

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

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