

## A Green Light



The *Sound Advice* Portfolio is up 7.8 percent since the beginning of 2015, as compared to 2.4 percent for the S&P 500.

We have an average profit of 67 percent in the *Sound Advice* portfolio, based on the prices that each position was recommended.

-- Gray Emerson Cardiff

We rely heavily on our Diffusion Indexes (page 11) to guide us through the major movements in stocks caused by the business cycle. Those indexes have been reliable except when the Federal Reserve launches extraordinary monetary programs.

An obvious example has been the Federal Reserve's quantitative easing (QE) program since the 2008-09 melt-down. The green light given by our Diffusion Index of Leading Indicators in April of 2009 was close to the bottom of the stock market. This Index signaled that the economy was soft and was providing an atmosphere for low interest rates. That signal lined up with the Federal Reserve's initiation of its first QE program.

However, as the economy recovered, our next signal came for our Diffusion Index of Lagging Indicators in March 2012, which warned that the economy was firming up and was now providing an atmosphere for rising interest rates. Yet, the Federal Reserve continued to embark on its QE programs, forcing interest rates to remain low. Although we were operating under a caution signal, we remained bullish and earned a 25.7 percent return from stocks in 2013.

Now we have another green light again from our Diffusion Index of Leading Indicators, which gave a zero reading in March, 2015. This reading reveals that the economy is soft and providing an atmosphere for low interest rates. Yet, for the first time in many years, we are hearing about the Federal Reserve raising interest rates.

On May 22, Federal Reserve chair, Janet Yellen, said in a speech that it will be appropriate for the Fed to raise rates at some point this year. Her exact words were:

*"Because of the substantial lags in the effects of monetary policy on the economy, we must make policy in a forward-looking manner. Delaying action to tighten monetary policy until employment and inflation are already back to our objectives would risk overheating the economy.*

*For this reason, if the economy continues to improve as I expect, I think it will be appropriate at some point this year to take the initial step to raise the federal funds rate target and begin the process of normalizing monetary policy. To support taking this step, however, I will need to see continued improvement in labor market conditions, and I will need to be reasonably confident that inflation will move back to 2 percent over the medium term."*

The key words in Yellen's speech are *normalizing monetary policy*, which means ending the QE programs that have kept short-term interest rates close to zero. The economy has normalized from its meltdown six years ago. Now it is simply time to normalize monetary policy.

The Federal Reserve is promising to normalize with a long and slow gradual increase in the Federal Funds rate, its key to controlling short-term interest rates. Evidently the Fed is concerned about pushing up interest rates too fast, and we can see why. Our most recent signal from our Diffusion Index of Leading Indicators tells us that the economy has softened up recently, and is not ready to absorb an abrupt hike in interest rates. It is not like we are at the end of a business cycle, when the economy is over-heating and inflation is threatening to spiral out of control. This is why Yellen says: *"To support taking this step, I will need to see continued improvement in labor market conditions."*

When will that be? It will likely be when we get our next signal from our Diffusion Index of Lagging Indicators, telling us that the economy is strong enough to put upward pressure on interest rates. Until then, we have a green light for stocks.

However, a green light for stocks is not a green light for bonds. Bond yields have risen recently as Europe's QE programs and other expansionary monetary policies in other industrialized nations are getting visible traction. We have also seen sharp fluctuations in the value of the dollar in relation to other currencies, which makes US Treasury bonds hazardous for foreign investors. A relatively small decline in the dollar can wipe out many years of the investment returns.

Rising core inflation has the same adverse impact. On the same day of Yellen's speech, the Labor Department released the consumer price data for April. The Consumer Price index actually declined 0.2 percent, and weak gasoline prices were cited as the primary cause. However, the so-called core CPI, which strips out food and energy costs, increased 0.3 percent, for a 3.6 percent annual rate. The recent core inflation rate wipes out the approximate 3 percent annual yield from long-term Treasury bonds.

Although bond yields have risen recently, they are still historically low, and the only substantial room for movement is upward.

We are recommending three ETFs designed to benefit from the inevitable rise in long-term Treasury bond yields. These ETFs 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 and bond yields always rise during an economic recovery. The ascent has never been smooth and this time has proved to be no exception.

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. We can project the movements of these ETFs based on any given scenario.

As part of the Federal Reserve's economic projections, each member of the Federal Open Market Committee (FOMC) makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot", and medians are taken to formulate the Federal Reserve's official prediction.

The most recent Dot Plot predicts that the Federal funds rate will be 0.625% at the end of 2015, up from zero currently. The Federal funds rate is predicted to be 1.875% at the end of 2016, and 3.125% by the end of 2017. Over the longer run, the consensus ranges between 3.25% and 4.25%.

Assuming Treasury bond yields move in tandem with the Federal Funds rate, here is what would happen to each ETF under the latest Dot Plot scenario:

TMV would rise to \$43 by the end of 2015, to \$79 by the end of 2016, and to \$137 by the end of 2017.

TBT would rise to \$58 by the end of 2015, to \$87 by the end of 2016, and to \$125 by the end of 2017.

TBF would rise to \$28.3 by the end of 2015, to \$34.6 by the end of 2016, and to \$41.5 by the end of 2017.

At some point in the not-to-distant future, as Europe's QE program and the ultra-easy monetary policies around the world stimulate economic growth, interest rates will rise globally, and cause bond yields to increase substantially.

## Refining Your Portfolio

In our mid-month e-mail update, we added [Valero Energy \(VLO\)](#) to the portfolio. We briefly explained our reasoning then, but will expand on the major points here.

Valero is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. We are adding VLO to our recommendations because it is an extraordinary investment value, especially considering that the company is in a highly-unique position to profit from the oil glut that is plaguing the US oil industry. Over the longer term, VLO is also well-positioned to continue operating as the country's most efficient refiner, offering growth in earnings and dividends.

### Why the Glut?

It's no secret that the US has an oil glut. Storage tanks at Cushing, Oklahoma, are brimming with oil. Primary pipelines even had to be reversed to carry excess oil to storage tanks. Yet, we still import close to 7 million barrels a day, even at peak US oil production of 9.4 million barrels a day.

So why not use up our oil glut, and import less oil?

It would not take long to use up the glut. According to the Energy Information Association (EIA), there are currently 484.4 million barrels of oil in US tanks. That is 86.3 million barrels more than there was one year ago, when there was no glut. That 86.3 million barrel glut is less than 13 days of

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our imported oil needs. Even every drop of the entire 484.4 million barrels in all US storage tanks equates to less than 70 days of imported oil.

The problem is that most US refineries are not set up to handle the type of oil that is coming from the US oil production boom from US fracking shale (through a combination of hydraulic pressure, horizontal drilling, and seismic imaging) which has opened up vast reserves that were previously too “tight” to recover.

There are several varieties of oil, but the most important demarcations are between light and heavy (a measure of specific gravity) and sweet and sour (a measure of the sulfur content). Oil is considered sour if it has a sulfur level greater than half a percent. The weight and sulfur content is critical to refineries because they are set up at great cost to refine oil with a specific weight and sulfur content.

The oil from US fracking is light, sweet, crude oil. However, until the recent US shale boom, world oil production had been shifting toward heavier and more sour crudes coming from Canada, the Middle East, Mexico, and the US Gulf Coast.

The primary cause of the US oil glut is the inability of most US refineries to process light sweet crude oil from shale. Valero's refineries are notable exceptions because it has the most flexible refineries, thanks to strategic capital spending in recent years. Valero's refineries can process just about any variety of oil, from light to heavy, sweet to sour. They are currently running at an industry high of 95 percent capacity, refining 2.9 million barrels per day.

### **Brent Versus Fracked Oil**

Brent is the international oil for the rest of the world. The name “Brent” stems from the Brent goose which lives in the North Sea, a prolific area for oil production. (Brent is also an acronym for the typical layers of an oil field: Broom, Rannoch, Etieve, Ness, and Tarbat.) Although both crudes are considered sweet oils, Brent oil is considered a more sour commodity than US oil coming from shale.

Prices of the world's refined products, such as gasoline and diesel, are based on world markets, and therefore, are based on Brent crude oil prices. However, other, less expensive crudes can be used and refined into these end products.

### **Flexibility Means Highest Margins**

Valero's refining flexibility allows the company to capture the highest margins among its competitors because it is able to capture the best price discounts of other crudes that are selling at below the price of Brent. For example, the glut of light, sweet oil from the US fracking boom has caused a discount in the price of US West Texas Intermediate (WTI) to Brent. The spread has been giving Valero a wide profit margin.

Valero is also well positioned geographically, with refineries scattered across the US, which can take

advantage of discounts from local capacity gluts. Its Gulf Coast refineries give it a particularly strong advantage because they are in the proximity of the Eagle Ford, one of the most prolific shale formations in the US.

To capture and process greater amounts of discounted US light crude from the Eagle Ford, Valero is expanding its facilities at its Three Rivers and Corpus Christi refineries.

The company is also increasing its rail-car capacity to move discounted light crude fracked from the Bakken Shale in North Dakota to its California refineries. Depending on discounts, Canadian heavy crude may also be transported to California as well as the Gulf Coast.

The US oil glut has been a benefit to Valero because of the price discount to Brent. The spread is likely to persist, especially as quantitative easing programs and expansionary monetary programs stimulate the global economy and the demand for Brent.

As the US oil glut is worked off, the price discount from Brent may narrow. However, Valero's flexibility provides other opportunities as well. The company's Gulf Coast refineries are well-located for accessing the low-cost Maya crude from Mexico, a heavy sour oil that Valero bought in 2014 for an average \$13 per barrel discount from Brent, which was a much larger discount than from US oil. In 2014, a significant 44 percent of Valero's refining was from heavy crude. The Maya discount continued to be 20 percent to Brent during the first quarter, even better than the 17 percent discount during the same quarter of 2014.

The discounts in the prices of crudes Valero was able to use in 2014, along with solid demand for gasoline products, improved margins by \$1.9 billion, or \$1.59 per barrel over the previous year.

During the first quarter, refining margins increased by \$1.49 per barrel over the same quarter last year, to \$12.39 per barrel from \$10.90. These margins translated into earnings of \$1.87 per share from \$1.54 one year earlier. However, despite its success, VLO remains an undervalued stock.

### **The Metrics**

Earnings are expected to be \$6.85 per share in 2015, which puts the price/earnings ratio (P/E) at 8.6, far below the industry average of 12.6, and even further below the S&P 500 average of 17. Other measures also reveal VLO is undervalued: Price/book value is 1.5 versus 2.2 for the industry. Three-year net income growth is 20.2 percent, versus the industry's average of 5.5 percent. The past and expected future growth rate should support a much higher P/E.

In addition, VLO raised its quarterly dividend two quarters ago, to 40 cents per share from 27 cents, giving it a yield of 2.7 percent. Valero also has a lower debt to equity ratio of 30 percent in comparison to the industry average of 50 percent.

## Unlocking Value

Another advantage Valero has is its highly successful Master Limited Partnership, **Valero Energy Partners LP** (VLP), which has returned over 85 percent to shareholders since its IPO in 2013. Valero is the General Partner with incentive distribution rights along with a 69.6 percent limited partner interest. Although VLP benefits from its stake in VLO, VLO also has the ability to “drop-down” assets to VLP at higher prices that could likely be obtained on the open market, effectively “unlocking value” for VLP shareholders. Eligible drop-down assets in 2015 include over \$1 billion of pipelines, terminals, storage tanks, and railcars. In March, VLO had a \$671 million drop down to VLP of its Houston and St. Charles Terminal Services Business.

## Risk/Reward

Valero Energy is one of the few energy companies that can benefit from lower oil prices because margins expand during such times. However, high demand for gasoline during times when oil prices are rising provide good margins too.

The risk profile is reduced by the company’s diversified operations as an international fuel oil wholesaler with close to 7,400 retail outlets in the US, Canada, UK and Ireland, under the brands Valero, Beacon, Ultramar, Shamrock, and Texaco.

Most importantly, because the future is never completely certain, the low-value metrics and its dividend put VLO in the low-risk category. Yet, capital gains should be strong because of Valero’s competitive advantages in turbulent oil markets. Evidently, the company agrees. Valero bought 5.4 million of shares VLO in 2014, and 7.1 million shares so far this year.

## Portfolio Updates - Energy

As one of the few deeply discounted values left in the market, carefully chosen energy stocks are bound to enhance the long-term performance of our portfolio.

**Chevron (CVX)** was introduced to the portfolio in April. Besides being a major international oil company, CVX is a vertically integrated oil company, which means it has operations in all phases, from exploring and drilling for oil, to transporting and refining, and even to retail sales at its gas stations. Profits from these various stages of production will change with the price of oil. When oil prices are high, margins are high from drilling, while margins are low from refining. However, the reverse is also true.

The dividend is currently \$4.28 per share. The depressed price of the stock puts the yield close to 4 percent. This yield does not happen often. The last time was during and shortly after the 2008-09 melt-down.

Natural gas will be a growth engine. Natural gas is poised to see the greatest growth in market share of all fuel types in the years ahead. As we point out regularly in these pages, a substantial disparity still exists between

the energy equivalent costs of oil and natural gas, which translates into an expanding natural gas industry.

Natural gas can be compressed and chilled to -260F into liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia, where demand and prices are much higher. In Europe the price of natural gas is three times higher than in the US. Prices are close to four times higher in Asia.

Chevron is using its financial might to expand its LNG deep-water infrastructure for its offshore natural gas reservoirs. There are two LNG projects underway in Australia. The one in Gorgon is scheduled to start up this year, and Wheatstone is scheduled to begin in 2016, with its nine production wells that have been drilled to the top of the gas reservoir. Close to 85 percent of the production from these gas reservoirs has been committed to premier LNG buyers.

**Chesapeake Energy (CHK)** is the nation’s second largest producer of natural gas next to Exxon Mobil.

CHK is still close to its low-point reached at the bottom of the 2008-09 crash. However, it is a much more solid company than it was then with free-spending chairman and CEO Aubrey McClendon at the helm. CEO Doug Lawler, an accomplished ex-Anadarko executive, has reduced overall expenses substantially. So far, spending levels have been within budget.

Chesapeake has over 9 million net acres of oil and gas assets in prolific producing areas, including the Marcellus and Utica Shale, as well as the Eagle Ford and Anadarko Basin. While most other energy companies are cutting back, CHK is forging ahead on its drilling plans to hold and develop production from this acreage.

Morningstar’s fair value estimate for Chesapeake is still \$27 per share, nearly double the current price of CHK.

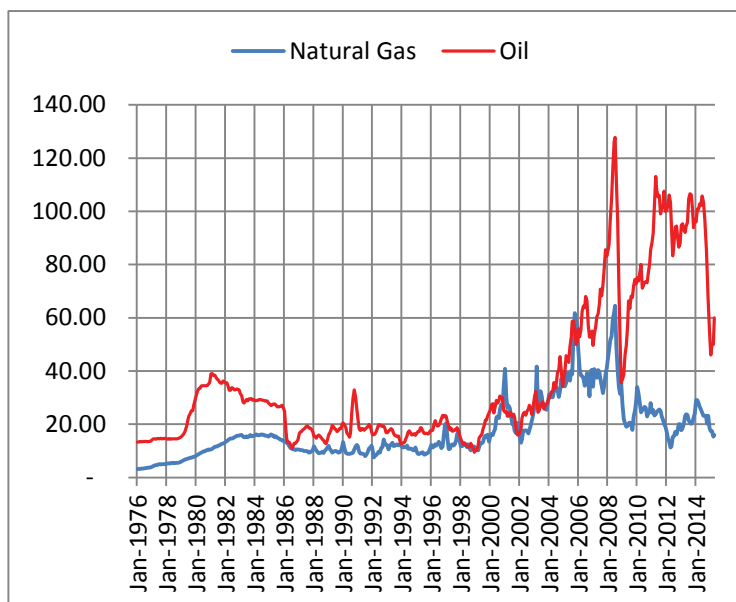
In late March, for the first time in 2 years, Carl Icahn raised his stake in CHK. He now holds more than 13 million shares which is close to 11 percent of the company.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly.

The growth outlook is bolstered by new facilities coming on line to transport US natural gas to the rest of the world. On the Louisiana coast, the largest super-cooling facility for natural gas (the Sabine Pass liquefaction terminal) is scheduled to be completed later this year, and will chill natural gas to -260F into liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia. This will be the first facility to export LNG from the contiguous US. Two more such facilities are scheduled for completion in 2018.

The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a

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



substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$60 a barrel, that is the cost of 5.8 million BTUs. However, with a market price for natural gas close to \$2.75 for one million BTUs, 5.8 million BTUs will cost \$15.95 (5.8x\$2.75). So the same amount of energy is available for 27 cents on the dollar, if it is in the form of natural gas rather than oil.

The chart above shows the historic relationship between the costs of these two forms of energy. 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. Most of the time, the costs of the two forms of energy have been closely aligned. They moved closer together when the price of oil dropped, but remain substantially apart. This difference still translates into an expanding natural gas industry.

**ICON Energy Fund Class S (ICENX)** is also a diversified way to participate in the recovery with a basket of substantial companies.

In the past, this fund has achieved growth even during periods of declining energy prices. ICON management looks for changes within the energy sectors to capture value, rather than simply depending on rising oil prices. For example, the profit margins expand on pipelines when the price of oil is low, because the cost and price of storage and transportation have little to do with the price of oil.

The fund has not suffered nearly as much as the drop in the price of oil. It declined 5 percent in 2014 but is up by that much this year, all during a 50 percent drop in the price of oil.

This fund is a great way to capture today's values and

profit from the recovery and changing landscape on a diversified basis.

**Transocean (RIG)** has been hammered by the sharp drop in oil prices. In February, RIG cut its dividend to 60 cents per share, which was not a surprise in view of the oil price crash. The current 60 cent dividend, which is not likely to be lowered again, is a solid 3 percent yield. This puts a floor in the vicinity of the current stock price because any substantial drop in the stock price from here would cause the yield to increase materially, which would be out of line with the industry.

In May, there were announcements of activities indicating that deep-water drilling slowdown is coming to an end.

The Norwegian Petroleum Directorate granted Statoil Petroleum permission for a deep sea well that will be drilled using *Transocean's Spitsbergen* drilling rig. This rig recently completed drilling two wildcat deep-water wells for Statoil.

Royal Dutch Shell was given US approval to resume oil exploration off Alaska's Arctic coast, and will be using *Transocean's Polar Pioneer* rig in a multi-year drilling program.

Also in May, the Petroleum Safety Authority of Norway gave the German driller, Wintershall, the approval to drill in the Northern North Sea using *Transocean's Arctic* rig, as well as approval for Shell to use *Transocean's Barents* rig to drill a new well in the Norwegian Sea.

It is important to keep in mind that even at today's peak production, the US still imports nearly half of its oil needs. Deep water drilling is still a necessary source for US and the world's oil needs.

Long term profits from RIG should be stellar from here.

## Portfolio Updates

Here are updates on the rest of the portfolio, in alphabetical order.

**Agrium (AGU)** has a broad mix of agricultural products and services that increases the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while worldwide population and per-capita income increases.

Agrium derives close to half of its revenue as the largest agricultural retail operator in the US from its 750 retail farm stores, offering seeds, fertilizers, and other crop chemicals directly to farmers. The retail network stretches across the country which allows collection of important weather, soil, and pest information that is used to gauge buying patterns. Agrium is continuing to add retail centers, which are an important source of growth and gives the company bargaining power with suppliers.

The other half of Agrium comes mainly from wholesaling fertilizer products. The company recently finished expanding its Vanscoy potash mine, which more than doubles Agrium's potash capacity.

Agrium is also expanding its nitrogen production capacity through its Borger nitrogen facility, along with other expansions in Egypt and Argentina. The company's nitrogen production in Alberta continues to have good margins because of access to cheap natural gas.

AGU estimates 2015 earnings to be in the range of \$7.00-\$8.50 per share, for a median of \$7.75. AGU is trading for a price/earnings (P/E) ratio below the P/E for the S&P 500. The annual dividend increased in the first quarter to \$3.50 per share.

**Boston Scientific (BSX)** has medical products that 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. BSX ended 2014 with 943 US patents.

The most significant recent approvals are in the cardiac care arena. One is the *Watchman* Heart Device, which is implanted on the left atrial appendage of the heart to prevent blood clots from atrial fibrillation. Another was for its *Subcutaneous Implantable Defibrillator*, which is implanted under the skin to provide protection against sudden cardiac arrest. Another was for its *Lotus Valve* system, an aortic valve implantation device for patients with severe aortic stenosis.

BSX is promoting alliances and presence in China by forming a partnership with the Chinese surgical stapler maker, Frankenman Medical Equipment Company, to develop and manufacture products in China, one of the world's largest and fastest-growing medical device markets.

**Ford (F)** is close to 10 times 2014 earnings which were depressed because of down time and preparation for 24 new or refreshed vehicles. Ford's new all-aluminum F-150 truck weighs 700 pounds less than last year's model, and gets close to 30 miles to the gallon. The F-150 is Ford's best-selling vehicle in the US and the company's most profitable product. Sales have been held back this year because the Kansas City facility has not been able to produce enough F-150 models. However, production capacity is scheduled to increase sharply within two months and catch up with demand.

Even with constrained F-150 supply, April sales revenue increased company-wide by 5.4% for all of the company's vehicles, the best April since 2006. Retail volume was the best in nine years.

On the cost side, Ford is reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by 2016, which will save billions of dollars through economies of scale, and give Ford more agility to adapt to changes in demand.

China was Ford's second most profitable market in 2014 behind the US. With sales of 22 percent of its cars,

Ford was only four percent of China's market share. Ford expects China alone to generate 40% of total sales by 2020.

Sales in China have been limited by Ford's ability to produce cars there. However, its new assembly plant in Chongqing will expand production by 360,000 more cars this year. Another plant in Hangzhou is scheduled to come online in 2016 to produce another 250,000 cars.

**Freeport-McMoRan Copper & Gold (FCX)** is the world's largest copper producer. Copper is woven into the fabric of the world's developed economies, 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. As the world's economies continued to expand into 2008, so did FCX.

At close to the top of the market in 2013, FCX decided to diversify and made a major acquisition of oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. The ownership of these assets, and the debt incurred for the acquisition, has caused FCX to suffer, along with the general decline in energy stocks. The company plans to continue developing these assets and may finance the project by spinning off these oil and gas properties through a public offering. If and when this occurs, we will evaluate the proposition.

However, FCX is still primarily a copper company. Today's quantitative easing programs and expansive monetary programs around the world are bound to translate into expanding economies and increasing demand for copper. The stage is being set for another cyclical run in FCX.

**Hersha Hospitality (HT)** is selling at a discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the US economic recovery. In addition, nearly a third of its major properties have been undergoing renovations and not producing their full income potential. HT saw the beginning of the benefits from completed renovations and new acquisitions during the third quarter of 2014.

We estimate the value of HT to be \$6.95, based on the most recent four quarters. We expect this value to increase as net operating income continues to increase as revenue increases from the 2014 acquisitions and renovations.

The Company repurchased approximately two million outstanding common shares for \$12.6 million during the first quarter of 2015 at a weighted average cost of \$6.36 per share. The Company will continue to consider further repurchases during periods of share price volatility.

**NCR Corp (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. In 2013, NCR increased its debt load to make two significant purchases -- Retailix, 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 which caused the stock to slide to its current attractive level. These acquisitions 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, and should be contributing to earnings substantially. Fourth quarter revenue reported in February was evidence that the acquisitions are beginning to prove beneficial.

During the first quarter, NCR saw strong demand and increasing revenues. However, the impact of the strong dollar erased these gains, causing net revenues to decline 2.8 percent. Despite currency headwinds, the company is maintaining its 2015 earnings expectation of \$2.70 per share because of better operating efficiencies and organic growth. Also helping to bolster growth is NCR's recent launch of its software platform, called Kalpana, which moves ATM software and operations to the cloud.

NCR is a value play. It is close to 10 times earnings – a steep discount to the market. Its price to sales ratio is 0.8 compared to the industry average of 1.8. Its price to book value ratio is 2.7 compared to the industry average of 6.0.

Values like this often attract activists who make large investments and then try to unlock the value. Last month we reported that some activists were quietly acquiring large positions in NCR. JANA Partners recently purchased 7.1 percent of the outstanding shares. Marcato Capital Management, also an activist hedge fund, has also purchased a large stake in NCR.

**Pfizer (PFE)** has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. The company is well positioned with several break-through drugs and treatments. The most recent to receive approval was *Palbociclib*. Trade-named "Ibrance", treats one of the deadliest forms of breast cancer by inhibiting two enzymes that promote the growth of cancer cells. It is expected to be a blockbuster for PFE, producing \$4 billion in sales by 2020.

Pfizer's current top selling drugs include *Lyrica* (for pain and fibromyalgia), *Prevenar* vaccines (for pneumonia and other infections), *Eliquis* (for non-valvular atrial fibrillation), and *Xeljanz* (for rheumatoid arthritis).

In the first quarter earnings call, the company projected 2015 earnings to be \$1.95-\$2.05 per share. This puts the current stock price close to 17 times earnings which is in line with the market as a whole.

**Retail Opportunities Investment Corp (ROIC)** 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.

As new properties are added, along with tenant upgrades, funds from operations (FFO) is bound to continue to rise, along with the dividend, and push the price of this REIT upward.

This trend continued through the most recent quarter, with FFO climbing 9.5 percent year-over-year.

ROIC pays an attractive dividend of close to 4 percent, which lowers its risk profile.

**Stryker (SYK)** provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, although SYK is best known for its orthopedic devices for artificial knees and hips. 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 and strong cash flow gives SYK avenues for continued diversified growth through acquisitions. Recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, and MAKO Surgical acquisition, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

Stryker recently announced it will be buying back \$2 billion of SYK in 2015, following the purchase of \$100 million in 2014.

**Symantec (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. Nearly all of the Fortune 500 companies are Symantec customers. According to Symantec's latest annual Internet Security Threat Report, cyber attacks against large corporations jumped by 40% over the past year. If there ever was a more certain growth industry, protection from cyber espionage is it.

In the first quarter earnings conference call, the company gave its 2015 earnings forecast of 1.85 per share. This means the current stock price is close to 13 times those earnings, which is below the market average.

By January, 2, 2016, SYMC will spin off its relatively small storage business, Veritas, as a separate company which will allow both companies to be more competitive and responsive to their respective industries. Veritas will be operated as a separate company prior to the spin-off by October 3, 2015. The separation will make SYMC a more attractive acquisition to large I.T. companies, with its strong balance sheet, along with its good cash flow and margins.

**Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL)** is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet including \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$1.87 billion in signed contracts to clean up military bases across the US. TTEK recently announced a two-year, \$200 million share repurchase program which will enhance earnings.

**Third Avenue Value 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. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams to come up with their estimates of intrinsic value. 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.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is replete with stellar values substantially below NAV with strong growth prospects.

TVRVX has a number of distinguishing characteristics.

This is a global real estate fund. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management also looks for opportunities in different points of a real estate company's capital structure by investing in senior debt in addition to a company's equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities in distressed times.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)**

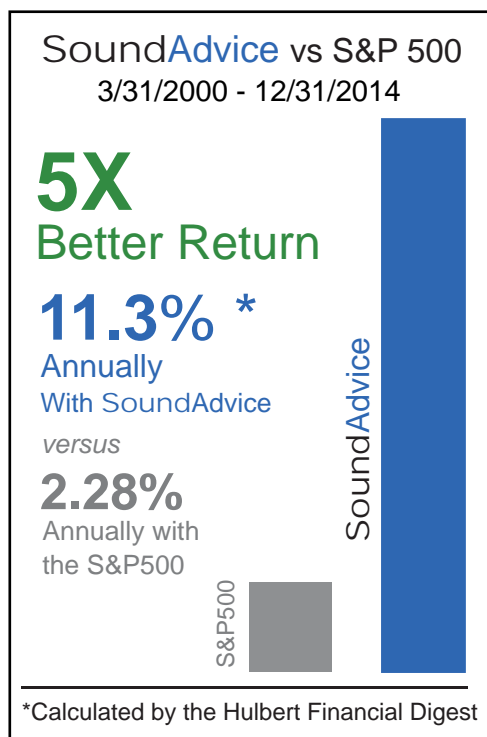
invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), and the ability to consistently compound NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

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.

**Vanguard REIT Index Investor Fund (VGSIX)** is recommended because it reflects the REIT industry. It produced a return of 30.31 percent in 2014. As an alternative, the **Vanguard REIT ETF (VNQ)** can be used, which produced a slightly better return of 30.41 percent in 2014. The performances of both are substantially identical during the last 3, 5, and 10 years. VNQ trades like a stock and is purchased through your broker who will charge a commission.

VGSIX can be purchased directly from Vanguard (800-841-7999) with no fee, or through your broker who may charge a fee. If you are investing \$10,000 or more, the **Vanguard REIT Index Fund Admiral Shares (VGSLX)** is the same fund except with a lower expense ratio of 0.10 percent (versus 0.24 percent with VGSIX). VNQ also has the same low expense ratio of 0.10 percent.

The performance of all three choices should be above-average REIT performers because most funds do not perform better than the averages over the years, and REITs usually out-perform the market.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Hersha Hospitality Trust	HT	NYSE	\$ 6.36	4.40%	\$ 7.80	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.33	3.67%	\$ 18.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 32.51	1.35%	\$ 34.00	BUY
Vanguard REIT Index Fund	VGSIX	NYSE	\$ 26.29	1.37%	\$ 35.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	\$ 103.96	3.00%	\$ 110.00	BUY
Ford Motor Company	F	NYSE	\$ 15.17	3.30%	\$ 18.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 19.65	1.02%	\$ 24.00	BUY
NCR Corp	NCR	NYSE	\$ 30.05	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 34.75	2.99%	\$ 36.00	BUY
Stryker Corp.	SYK	NYSE	\$ 96.13	1.10%	\$ 97.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 26.16	1.07%	\$ 26.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 23.71	0.00%	\$ 27.00	BUY
Xerox	XRX	NYSE	\$ 11.42	2.19%	\$ 14.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 14.11	2.48%	\$ 19.00	BUY
Chevron	CVX	NYSE	\$ 103.00	4.16%	\$ 120.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 32.65	1.01%	\$ 37.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 14.38	0.63%	\$ 18.00	BUY
Transocean	RIG	NYSE	\$ 18.85	3.18%	\$ 22.00	BUY
Valero	VLO	NYSE	\$ 59.24	4.51%	\$ 65.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 18.27	0.00%	\$ 19.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 30.86	0.00%	\$ 38.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 25.28	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 46.47	0.00%	\$ 55.00	BUY
Symantec	SYMC	NASDAQ	\$ 24.63	2.44%	\$ 27.00	BUY
Tekla Life Sciences Fund	HQL	NYSE	\$ 27.71	0.00%	\$ 30.00	BUY

**Notes to the table:**

Prices are as of 5/29/2015. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

**Xerox (XRX)** 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.

Along these lines, XRX is aiming acquisitions at companies offering IT solutions for health care management. In May, XRX announced its acquisition of Healthy Communities Institute (HCI), a company with a leading cloud platform that gathers community health data from local clinical visits and healthcare claims, and makes the data accessible to hospitals and health agencies for

assessing disease, infection, demographics, and other factors for specific communities.

XRX delivered strong profit and cash flow in 2014 with encouraging growth throughout the year, but had a disappointing first quarter, with earnings of \$0.21 per share. The stock dropped on the news, and has since been languishing in the \$11-12 range. The earnings short-fall was due to higher-than-expected startup costs for setting up some of the old legacy government health care accounts, which did not have allowances for such contingencies. However, this should not be a recurring problem.

The recent dip in the stock price puts it close to 11 times earnings, very cheap relative to the rest of the market.

## 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 \$12.5 million in stocks and to \$1.52 million in houses.

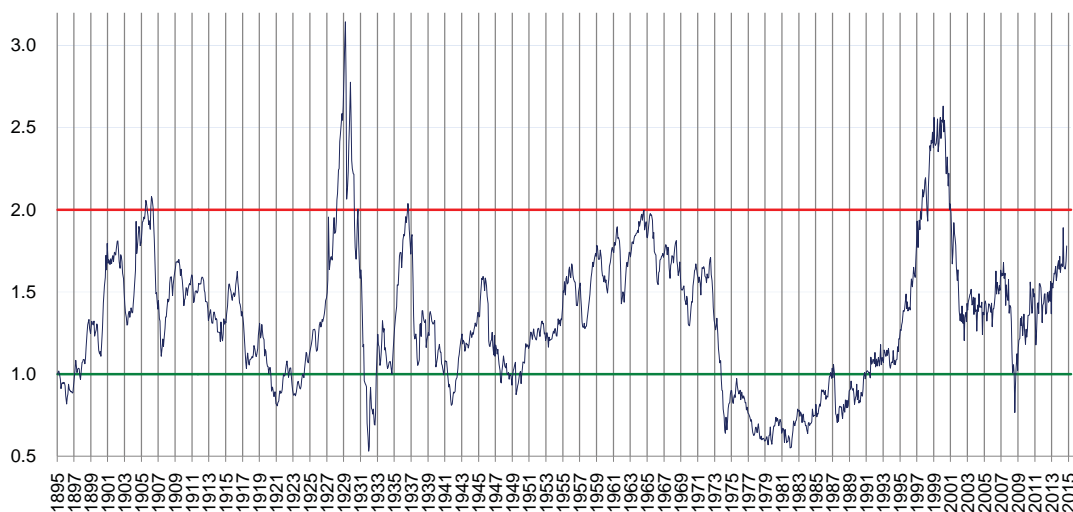
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$496 million, or 39.7 times more money—the 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 SoundAdvice Risk Indicator is 1.77. This reading reveals that stock prices are substantially 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 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 soft economy is providing an atmosphere for stable or declining interest rates.

The most recent zero reading was in March, 2015.

The previous zero reading was in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

**The SoundAdvice Diffusion Index of Lagging Indicators** will be giving the next signal. This Diffusion Index 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 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 the Federal Reserve's expansive monetary policy and its quantitative easing program which has been distorting the natural business cycle.

### 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 3.0 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
Mar-15	2,080.0		
Ave +/-	32.1%		3.0%

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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