Gray Cardiff's

# SOUND ADVICE

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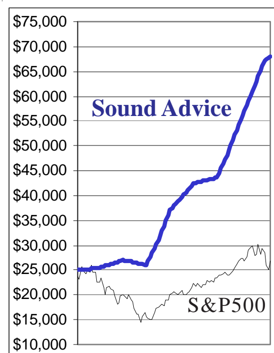
## Malign Neglect

Consensus on Wall Street has shifted about Ben Bernanke. Roundly criticized earlier for raising rates because he believed inflation was more of a menace than a slowing economy, and then, as evidence built that a recession might be on the horizon, for being too timid when he did reduce them, the Fed Chairman is lately being hailed as a bold, almost entrepreneurial warrior fighting to prevent a collapse in the credit markets. His weapons are, to say the least, unconventional.

Though the banks, brokers and others who want us to believe they too are victims, two overlapping views seem to dominate as to whether any of this could have been avoided. One version is that no one saw it coming. We had no inkling of what mischief could come from subprime lending to borrowers of dubious quality, promiscuous rating of securities built on those mortgages, the dispersal of risk created by derivatives, and a climate in which lack of regulation was seen as a good thing. This view is very popular on Wall Street and among regulators. We had never seen housing prices nationally soften for any significant period, they claim, and we had those beautiful mathematical models to project how various derivatives would perform under any scenario our quants could conceive.

The less charitable way of looking at how this could have happened—and the one that rings truer—is that no one cared to think too much about what they were doing. This view is common among some worrywarts in the risk analysis profession and nearly universal among those who dodged the damage. Their choice of words is similar. One expert in financial risk analysis says: "If it is too complicated for most of us to understand in 10 to 15 minutes, then we probably shouldn't be doing it." Another, the treasurer for Washington state, who passed when bond salesmen pitched their new fangled products, observed: "They get paid if they convince me to do something whether it's in my best interest

### Sound Advice versus the S&P 500




**Since 1-1-2000, an Investment of $25,000 becomes:**

**$26,793 with the S&P 500**

**$67,896 with *Sound Advice****

**= 23 Times More Profits**

* These returns assume an equal amount is invested in all ***Sound Advice*** Model portfolio positions at the time of the initial recommendation.

**The downfall of Eliot Spitzer, the ex-Governor of New York State, brought glee to Wall Street, where Spitzer as Attorney General once investigated and extorted settlements from brokerages and banks. A cheer erupted on the floor of the NYSE when news broke about Spitzer's misadventures.**

**We're not overlooking Spitzer's betrayal of his family and his state's citizens, but we also are not forgetting that Spitzer took on practices that other officials and journalists had winked at forever.**

**The only difference between what Spitzer and his rented friend did and Wall Street does is that at the least the lady Spitzer employed faithfully delivered what she promised.**

***The Wall Street Journal* editorialized on the day Spitzer resigned that his legacy is mixed. One financial biggie noted that Wall Street today produces less research because of Spitzer's punishing Wall Street firms for letting their lust for big investment banking fees distort the truthfulness of their analysts' reports. Well, duh. Who cares about the volume of research when the quality of what they pumped out in those "good old days" was untrustworthy and sometimes flat-out deceptive.**

**In fact, the quality of Wall Street research always will be suspect because even ethical analysts are too close to the companies they cover and too prone to move as a group.**

**Wall Street loves to view small-lot, amateur investors as a contrary index: when they're bullish, it's time to go short. I wonder how well a parallel index of analysts would work? I suspect, very well.**

***--Gray Emerson Cardiff***

*Sound Advice, 939 Hartz Way, Suite 210, Danville, CA 94526. 800-825-7007.*

or not …If it takes more than 10 minutes to explain it, I don't want to buy it.''

Both versions agree on this: few understood the risks they were taking on, and apparently there was no one responsible for monitoring, forget about regulating, what was developing to alert buyers to how risky these wonderful financial products were. Furthermore, until matters became truly desperate, no one at the Fed or in the administration seemed ready to confront boldly what was developing. The tumultuous events of the last few weeks testify to how bad things had gotten before the Fed stepped into the breach and the White House reluctantly decided it was long past time to set aside free market ideology and lend a hand.

Consider this: how could Bear Stearns have been worth a "depressed" $30 a share at the market close on a Friday but be sold off to JP Morgan as effectively bankrupt for $2 a share on Monday morning? Forget that JP Morgan adjusted the "price" to $10, or that 14 months before Bear had been a $170 stock.

Why does this all seem so familiar? Go back to the mid-1990s when "irrational exuberance" captured the market's Zeitgeist. For someone who obsessed on risk and its pricing—as did IE's father, Alan Greenspan—the natural response to a market that was becoming less and less concerned with risk would be to make risk more expensive, as in raising the margin requirements to buy stock (at the time and now, they were at 50%). Instead, Greenspan shrugged. Though at the time he acknowledged the Fed could raise rates under Regulation T, any change, he lectured, would be empty, because there were other ways for investors to control shares through options and more exotic strategies. Instead, he let the market run free, which ended badly. At the time, I wondered, if the Fed truly was responsible for controlling rampant speculation but creative investors could neutralize Reg T, why not figure out how to control these synthetic ways of outfoxing the Fed? Never happened.

Jump forward to the Enron debacle. Enron was a nice, profitable gas transmission company that never caused anybody any harm until it mutated into a quasi-investment bank that commoditized energy and broadband capacity and created an informal (and occasionally fictitious) market for them. What allowed Enron to become "Enron" was the Commodities Futures Trading Commission under chairwoman Wendy Gramm, which in the twilight of the first Bush administration, voted to exclude from regulation the sorts of contracts Enron pioneered. When it all fell apart, bullish Wall Street analysts admitted that they never really had understood Enron's accounting and profits, and since regulation was almost non-existent, apparently no one else did either.

And now we have the mortgage crisis. The problem again owes much to creative financial devices born this time at quasi-banks that were lightly regulated. The traditional banking system, and this includes Savings & Loans, is relatively well supervised, a result of ugly experiences in the past. Traditional banks self-fund their loans through deposits. They are required to maintain substantial reserves against the possibility of market difficulties. The new model did away with depositors, and instead sucked in cash from all over the world, mediated through Wall Street brokers, investment banks and mega-banks that worked hard to stifle interfering regulators.

The resulting loans were recycled as collateralized debt obligations, sliced and diced to fit investors' tolerance for risk, and then dispersed through Wall Street back to investors around the world. Rather than regulators, private rating agencies vetted these securities. Apparently the rating agencies failed to detect weakness. Reserves were thinner than those required at banks. When it all fell apart, we were again told that the entire universe of mortgage securities and even more so derivatives was too complex to understand. Indeed, *The Wall Street Journal* thought having Bear Stearns go bankrupt would have been helpful to the extent that only then would "Bear's trading counterparties and other creditors have [had] to show themselves and explain their positions to a public examiner. And then bankruptcy lawyers would have to pore through each and every one of Bear's assets and liabilities, making the full autopsy public." To extend the medical analogy, instead of an autopsy, would it not

*(continued on page 6)*

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# Are Financials Worth the Price?

Dodge & Cox Stock Fund recently reopened to new investors and their cash because of opportunities the rotten market over the last year is creating for value investors. As perverse as it might sound even to experienced investors, weak markets offer the greatest likelihood of long-term profits. The only catch is that such markets are also the most emotionally difficult. As repeated studies have shown, investors are loss averse, that is, any suggestion that an investment might be unprofitable (and which investment doesn't involve that prospect?) becomes an almost insurmountable barrier, which brings us to our four current investments in financials and REITs. This is volatile and risky territory, at least in the short-term. We are confident that eventually buyers are going to be richly rewarded, and in the process they are equally certain to be richly tormented as well.

### *AMERICAN INTERNATIONAL GROUP*

Dodge & Cox last quarter began to buy American International Group (**AIG—NYSE**), America's biggest property and casualty insurer, and a major figure in almost every aspect of the insurance, investment and financing sectors. Growth in our mature economy is modest. Much faster growth potential exists outside the U.S., especially in Asia and particularly in Japan and China where AIG has spent the post-World War II period developing its business. In China, AIG is the only foreign company to operate a wholly owned insurance company. In Japan, it is the biggest seller of life insurance. In all markets, its size and reputation are major assets.

AIG entered the Sound Advice portfolio in the April 2005 issue at $51.91, levitated to just under $73 in December 2006, fell back to the mid-$60s before rising last May almost back to its 2006 high before beginning to tumble under $40 in mid-March after taking heavy write-downs. AIG announced that for the fourth quarter, it had lost $1.25 a share on charges of $2.83 a share, the result of mark-to-market pricing in its super senior credit default swap portfolio .

AIG has not traded at this price since the fall of 1998 when it was in the middle of a robust run on the way to its all-time $100+ high. More important than the dollar price are the valuations. In late 1998, AIG traded at a Price to Sales ratio of 6.2, a Price to Earnings ratio of 24.1, and a Price to Book of 3.7. Currently, AIG trades at a P/S ratio of 1, a P/E of 17.9, and a P/BK of 1.1. The earnings ratio is distorted to the high side by the impact those charges had on earnings.

Last year, the insurance business was seeing premium rates softening due to competition, and a slowing economy that impacted returns from their investment portfolios. Speaking broadly, were the financial markets and particularly the insurance business simply moving through their normal cycles, we presume the shares of AIG and its competitors would be so-so performers as revenue and profit growth slow.

But these hardly are normal times for financial service companies, and performance rather than so-so has been ugly. AIG is getting hit on several fronts. Its finance arm originates primarily first and some second mortgages, it invests in mortgage-backed securities and Collateralized Mortgage Obligations, and provides credit protection for others' contracts through super senior credit default swaps. We had believed that AIG, though it had exposure to all these facets of the mortgage and credit markets, had been conservative in that exposure. Recent events contradicted that view as assets have been written down. The pivotal issue for us is whether those write-downs are written in ink or pencil, since in almost all cases AIG intends to hold them to maturity.

### *THE Q4 MASSACRE*

What had been a serious slide as AIG shares reflected both investor concerns about the insurance business and anxiety over the credit crisis turned into a waterfall in February when fourth-quarter results destroyed targets for that quarter and the year. The most troubling number was $11.47 billion in "Unrealized market valuation losses on AIGFP (AIG's financial products arm) on super senior default swap portfolio." Swaps insure lenders against loss should loans go bad. Understandably, in a market experiencing defaults and anxious about more to come, investors worry how much AIG might have to pay in a worse case scenario?

The market for such credit swaps has dried up, which has made it difficult for those who want or must sell their credit swaps. Prices are determined now not efficiently but under duress. AIG has no intention of selling its credit swaps, but that doesn't mean it is insulated from lower prices.

This is the crux of AIG's (and others') predicament. Because of abuses that were uncovered during the Enron and other financial fraud cases, accounting rules now

demand that financial assets be marked to market, that is, priced to what they might trade at in the current market rather than carried at some arbitrary number determined by an abstract mathematical model. Enron, for example, concocted elaborate and entirely fictitious models that showed generous profits, which could be booked immediately regardless of how dodgy the underlying "securities" in reality were. AIG is no Enron.

Though mark-to-market accounting provides transparency, we are looking through glass that distorts. In the case of AIG's billions in credit swaps, even if the current market prices were accepted as firm and true, the "losses" have more to do with accounting than with value. AIG observes in its most recent 10K, "that the unrealized market valuation losses recorded on the AIGFP super senior credit default swap portfolio are not indicative of the losses AIGFP may realize over time… Based upon its most current analyses, AIG believes that any credit impairment losses realized over time by AIGFP will not be material to AIG's consolidated financial condition, although it is possible that such realized losses could be material to AIG's consolidated results of operations for an individual reporting period. Except to the extent of any such credit impairment losses, AIG expects the unrealized market valuation losses to reverse over the remaining life of the super senior credit default swap portfolio. [our emphasis]" We should note that the swaps have not cost AIG a dollar in payouts. Despite AIG's confidence that the write-downs do not reflect permanent impairments, the media continues to hammer away at the company for dabbling in dangerous investments. Marty Whitman, who knows more about distressed credits than perhaps anyone on Wall Street, considers media coverage of complex securities in Third Avenue funds' portfolios as naive and " strictly 'amateur hour'." So too in how the media treats AIG's swap situation.

**This is volatile and risky territory, at least in the short-term. We are confident that eventually buyers are going to be richly rewarded, and in the process they are equally certain to be richly tormented as well.**

Super senior debt obligations represent the most protected creditor for any particular debt obligation. Thus, for a super senior debt obligation to go into default every lower layer, starting with equity and running through BB, BBB, AA and AAA would have to fall into default. Though such a drastic collapse is not impossible, AIG asserts that in vetting these arrangements it has been very conservative in its projections. Furthermore, once entered into, these deals are repeatedly stress tested to determine whether earlier assumptions were flawed or projections have failed. In such instances, reserves would be established to cover the expected losses. To date, AIG has established no reserves, because it has no reason to believe the risk has increased.

As the credit markets recover—and we finally are seeing tentative evidence of a recovery—we presume AIG will reverse much if not all of these write-downs, thus boosting the balance sheet and restoring losses taken on the income statement. Under those circumstances along with improvements in its multifaceted insurance and financial services businesses, AIG should do just fine. At this point, we are experiencing maximum pessimism about AIG. Valuations demonstrate that. What we need is patience and time.

**HRPT Property Trust (HRP—NYSE)** is an income-oriented real estate investment trust. REIT income is not taxed at the corporate level but is passed through directly to shareholders. Because they enjoy this special tax advantage, most REIT distributions are taxed as ordinary income and do not enjoy the current 15% other corporate dividends do. However, this is moot in tax-deferred accounts such as IRAs.

*Sound Advice* has followed REITs closely ever since they became available, recommending them lustily whenever they got neglected. The last time was in the late 1990s during the tech bubble, when REIT revenues were growing but the share prices were falling. At the time, yields were in the teens. Between then and early 2007, REITs were white-hot. Then, as concern over rising interest rates and a slowing economy chilled investors' ardor, REITs began to drop and then cascaded to prices that in many cases put them back where they were before the REIT rally ignited in 2000. At their recent low, HRP sat where it was in November 2000 at \$6.31 and yielded 12.7%. The shares topped out last February at \$13.54 and yielded 6%. At both extremes, HRP generated a higher yield than almost any other REIT, because its managers prefer income over growth.

How do they do that? First, they avoid high-priced major markets such as the downtowns of Manhattan, Boston, Philadelphia, Chicago or Los Angeles, where rents can be moved higher and property appreciation can be extraordinary but where trophy properties are expensive and leasing costs can be high to attract the right tenants. HRP when it does venture into these central business districts, avoids trophy properties.

### Fund Notes

**Two of our funds have changed how and to whom they are marketed, which means we will have to sell one and explain how to buy the other. Excelsior Value & Restructuring Fund (UMBIX) now belongs to the Columbia family of funds, which henceforth will offer it only as a load-fund, that is, it will charge an upfront fee for new buyers that is intended to compensate brokers and other financial advisors. We do not include such shares in our portfolio, and thus must sell it. If you are fortunate enough to own UMBIX, we encourage you to maintain or even add to your position, since we have the highest regard for the fund's manager and his approach.**

**USAA Precious Metals & Mineral Fund (USAGX) along with the other USAA funds is no longer availble directly from USAA unless you are a member (restricted to active military, their dependents and a smaller group of government employees). However, you can still buy shares through some brokerages such as Vanguard and, according to USAA, any other that clears their trades through Pershing Securities. Given that USAGX remains available to all subscribers, we will continue to recommend and follow it.**

Of HRP's 35.3 million square feet of office and 29.1 million of light industrial space, 51% sits in six core markets: Philadelphia, Washington DC, Honolulu, Boston, southern California and Austin, Texas, and remains predominantly suburban, though that has shifted slightly over the last few years. New properties are bought fully or nearly fully leased , which diminishes sales and remodeling costs. Furthermore, HRPT relies on tenants that tend to stay put: government and medical offices occupy respectively 20% and 14% of HRP's space. When they do venture into first-tier markets, properties tend to be in the suburbs where properties are cheaper. Management also does not emphasize rapid growth, preferring to bide its time and buy properties that show superior cash flow.

So why has HRP been sliding for the last 14 months? Aside from the obvious weakness for almost every REIT, HRP's ability to maintain its outsized distribution has emerged as a primary concern. During its last conference call following release of Q4 results, an analyst challenged management as to whether they can maintain that distribution. The answer: HRP, even if market conditions remain negative, can continue the payout for at least another two or three years. Only at that point would it be necessary to reconsider matters. Apparently the analyst did not like the answer. He put out a Sell recommendation the next day.

We believe that two or three years is an eternity, and that if experience is any guide, market conditions should be changed for the better by then. HRP's properties, while not sexy, have solid rent rolls, though loss of a big tenant, Comcast in suburban Philadelphia is a challenge. As we go to press, HRP and REITs in general are showing strength. Whether this is simply a response to the compelling yields they offer, or recognition that the falling interest rates that make those yields attractive also make life easier for real estate owners to strengthen their balance sheets, or whether investors are looking ahead to an inflationary environment that could favor this asset class, a rebound is occurring. Short-term, who knows how long it can last. Long-term, prices are too attractive not to buy.

### *FINANCIALS DIVERSIFIED*

If you want to get into financials but the idea of doing it with a single company is not comforting, Icon Financial Fund (ICFSX) gives you not just diversification but a discipline that should appeal to value investors.

In the January issue, we explained the proprietary evaluation method all Icon funds employ (we also own the **Icon Energy Fund**). Simply put, Icon funds select sub sectors within industries they consider, based on a proprietary model, undervalued, and then overweight their portfolios in such subsectors. Obviously, a fund devoted to financial services has been a loser over the past year, but once these companies regain stability, the rebound should be solid. The last time banks and other financial services companies were in such low repute was in the early 1990s, which became a springboard for market-beating outperformance.

ICFSX's method tends to keep it out of the most perilous portions of an industry, which explains why the fund escaped most of the damage from mortgage-related positions, and why its biggest bank and investment bank positions, JP Morgan, which just snapped up the remains of Bear Stearns and Goldman Sachs, the most profitable Wall Street investment bank, are its two largest positions. The flip side of this conservative approach is that by avoiding the more risky portions of a sector, Icon funds tend not to benefit from abrupt reversals. We are willing to accept the lower upside during rocketing reversals in exchange for the solid value selections dictated by the funds' method.

# Sound Advice: Are Financials Worth the Price?

In February, believing that REIT yields had climbed high enough to justify revisiting the asset class, we recommended the **DWS RREEF Real Estate Fund II (SRO—AMEX)**, a closed-end leveraged fund aimed primarily at providing above average income. The title was "Yield Now, Capital Gains Later," which captured what we expect. Since then, in a volatile market, the fund has appreciated modestly (+3.3%) including one quarterly distribution ($0.381), which annualized works out to 11.5% without considering last year's capital gains distribution. The fund's yield is high at the moment, because (1) REITs are out of favor (2) the fund is selling at a discount to its Net Asset Value (currently -9.9%) and (3) the fund uses leverage to enhance its yield.

The fund appeals to us for several reasons besides the fat yield. Looking at its portfolio, we believe the managers aim for more than just yield by putting money not merely into REITs, almost all of which are being avoided ,but especially into out-of-favor subsectors. For example, hotel REITs have been avoided by most funds lately, since in a slowing economy, hotel occupancy rates and prices soften. Conversely, with home ownership shrinking as real estate cools, most REIT fund managers gravitate toward apartment REITs. It appears that the managers at SRO are doing the opposite, which makes sense, since with prices down for hotel REITs, their yields move higher, and also are set up for future appreciation.

As for leverage, the like many income-oriented closed-end funds, SRO borrows short-term to buy more assets. Depending on the spread between those borrowing costs and the yield from what they buy with the borrowed funds, CEFs can get a nice bump in earnings. In a rising market, this enhances not just yield but also NAV. In a falling market, the higher yield remains but capital losses are magnified. We can accept the two-edged sword. However, during recent market disruptions, the funding source, so-called Auction Rate Preferred Shares (ARPs) have ceased to function as bidders at these auctions are few. The auctions' failure triggered a default mechanism that has boosted what SRO must pay to ARP holders, and has made the market wary. Still, even the somewhat higher payout preserves a profitable spread between that cost to SRO and what it receives from the REIT shares purchased with those funds.

There is evidence SRO shortly will find an alternative method to support its borrowing, which might explain why the shares have been moving higher this month. In any case, if our take on REITs is right, we expect SRO will not just provide income but should also appreciate as REITs recover their audience. ***SA***

("Malign Neglect," continued)

have been better to have applied some preventive care first? Healthy diet, no smoking, more transparency, less leverage?

What does this have to do with us as investors? As regards financials, which we have been edging into this year, we are seeing the beginning of the end of the panic. As the Fed and eventually the taxpayers pour billions into keeping the markets from self-destructing, we are going to recognize that markets do not magically regulate themselves, and that the same shortcomings we see in ourselves are only amplified by markets. If we need traffic cops to prevent reckless behavior, why do we not need financial traffic cops as well?

As value investors, we think it is time to start collecting what is salvageable amidst the rubble. As for larger matters, for starters, as investors we must understand what we are buying and selling.

We don't pretend to expect investors to understand exactly how flash memory operates versus a hard drive, but anyone who puts money into either technology should know the advantages of one versus the other. If you buy a REIT, look beyond the yield to understand the subsector in which it operates and have at least a passing acquaintance with its balance sheet. If you like a pharmaceutical company, know what's in the development pipeline, and be aware of issues surrounding existing drugs. None of this awareness will prevent problems, but at least you understand the proposition.

If the investment is so complex that it takes more than 10 minutes to explain, maybe you should pass on it. If the investment pitch is so simple that all it takes is five seconds to scribble the ticker symbol, maybe you need to spend at least another 10 minutes exploring it. We also need to be skeptical about whatever Wall Street is selling. Always remember this: Wall Street is a merchandiser that needs to move inventory. Ultimately, it doesn't care whether the product fits. It just needs to move it.***SA***

# Portfolio Updates

Dramatic moves by the Federal Reserve were the engine for last month's bounce in stock prices. Given that Bear Stearns, the fifth largest investment bank in the country, effectively went bankrupt and the Fed in order to keep the credit markets from chaos enlisted JP Morgan to ride to Bear's rescue, that energy prices remain stubbornly above $100, that unemployment numbers continue to rise, that consumers are saying they are as depressed as they have been in decades, that the market staged a recovery runs counter to what prudence would suggest. But the market does not exist to confirm what we expect. In fact, it really plays just the opposite role.

Since the last letter, the Dow and S&P 500 are up 6%, and the Nasdaq 7.2%. The *Sound Advice* portfolio added 4.7%. The lag can be attributed to weakness in commodities, our relative underweighting in financials, the retreat of a handful of positions that had been extraordinarily strong earlier in the year, and a hard fall taken by Schering-Plough.

**Dodge & Cox Stock Fund**, which last issue we welcomed back into the portfolio, was up 3.7% after it paid a $4.68 distribution. With our need to sell **Excelsior Value & Restructuring Fund** (see page 5: "Fund Notes"), DODGX is now our lone large cap value fund.

Two trends that had characterized the market this year went into reverse last month: Financials and commodities, which had been moving in opposite directions continued that divergence, but this time it was the financials in ascendance. A partial explanation is the dollar that paused its decline, perhaps in relief that the Fed had acted to stabilize the credit markets. But we think it is only a pause, not the start of a resurgent dollar. The very tools the Federal Reserve, the White House and Congress are applying to the stressed financial markets and to a dead-in-the-water economy are likely to generate more inflation.

Ultimately, the dollar, we believe, still has further to fall, and that demand for commodities will continue. Nonetheless, as this issue makes clear, we think that financials have been far too abused to stay this cheap much longer. Indeed, the four positions we showcase in this issue were up 16% (**DWS RREEF Real Estate Fund II**) 10.3% (**American International Group**), 9.1% (**HRPT Property Trust**) and 7.3% (**Icon Financial Fund**).


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For commodities, the party was quieter: **USAA Precious Metals & Minerals Fund** fell 5.3%, **Agrium** 3.2%, and **Anglo-American** 2.4%, but we did get a 4.2% upmove from **Plum Creek Timber**, perhaps in response to hopes the housing market has seen a bottom. Energy was also in the black: **Icon Energy Fund** moved 5.9% higher, **Transocean** 5%, **Royal Dutch** 4.8%, while **EnCana** was flat for the month. The **Prudent Bear Fund** had to swim against the tide. Weakness in precious metals, which the fund is long, also shoved the shares lower. BEARX dropped 7.8%.

Neither financials nor energy were our best performers. Instead, a motley collection of decidedly gritty companies topped the list. Indeed, we are perplexed by the market's sudden appetite for companies that provide basic materials and solutions. Though ours is a small sampling, the high performers suggest some investors are putting money into businesses that require a healthy economy to flourish. For example, **Fastenal**, the retail distributor of connectors and assorted hardware and materials, continued on a tear that started in January when it surprised with higher than expected results. Since then, the shares are up nearly 50%. Over the last month, it

# Sound Advice Portfolio for April 2008

| Income With Growth | Symbol | Exchange/ Phone | Price/ N.A.V.* | Yield** | Buy Limit | ACTION |
|---|---|---|---|---|---|---|
| DWS RREEF Real Estate Fund II | SRO | AMEX | $13.30 | 13.26% | $14.00 | BUY |
| HRPT Properties | HRP | NYSE | $7.30 | 11.51% | $8.00 | BUY |
| **Diversified Growth** | | | | | . | |
| Agrium | AGU | NYSE/TSE | $69.23 | 0.16% | $75.00 | BUY |
| American International | AIG | NYSE | $47.83 | 1.67% | **$52.00** | BUY |
| Boston Scientific | BSX | NYSE | $14.11 | 0.00% | $16.00 | BUY |
| Coca-Cola Enterprises | CCE | NYSE | $24.34 | 0.99% | $28.00 | BUY |
| Disney | DIS | NYSE | $31.24 | 0.99% | $37.00 | BUY |
| Dodge & Cox Intl.Fund | DODFX | 800-621-3979 | $42.98 | 6.42% | N/A | BUY |
| Dodge & Cox Stock Fund | DODGX | 800-621-3979 | $121.63 | 14.73% | N/A | BUY |
| Excelsior Value & Restructuring | UMBIX | 800-345-6611 | $55.11 | 1.51% | N/A | **SELL** |
| Fastenal | FAST | NASDAQ | $47.89 | 0.96% | **$52.00** | BUY |
| Fidelity Japan Fund | FJPNX | 800-544-8888 | $13.58 | 0.29% | N/A | BUY |
| Gabelli Global Telecom | GABTX | 800-422-3554 | $23.37 | 0.99% | N/A | BUY |
| Honeywell | HON | NYSE | $58.27 | 1.72% | $64.00 | BUY |
| Insituform Technologies | INSU | NASDAQ | $15.40 | 0.00% | **$19.00** | BUY |
| Johnson & Johnson | JNJ | NYSE | $65.73 | 2.53% | $73.00 | BUY |
| Liberty Capital**** | LCAPA | NASDAQ | $16.69 | 0.00% | $20.00 | BUY |
| Mattel | MAT | NYSE | $21.64 | 3.47% | $25.00 | BUY |
| Microsoft | MSFT | NASDAQ | $29.16 | 1.51% | $36.00 | BUY |
| Molson Coors Brewing | TAP | NYSE | $54.48 | 1.51% | $59.00 | BUY |
| Odyssey Healthcare | ODSY | NASDAQ | $9.51 | 0.00% | $11.00 | BUY |
| Sara Lee | SLE | NYSE | $14.39 | 2.92% | **$17.00** | BUY |
| Schering-Plough | SGP | NYSE | $16.12 | 1.36% | **$22.00** | BUY |
| Sony | SNE | NYSE | $41.90 | 0.52% | $55.00 | BUY |
| Sprint Nextel | S | NYSE | $6.52 | 1.53% | $10.00 | BUY |
| Superior Industries | SUP | NYSE | $21.49 | 2.98% | **$24.00** | BUY |
| Tetra Tech | TTEK | NASDAQ | $20.02 | 0.00% | $26.00 | BUY |
| Third Avenue Value Fund | TAVFX | 800-443-1021 | $55.96 | 3.74% | N/A | BUY |
| United Parcel | UPS | NYSE | $74.41 | 2.26% | $76.00 | BUY |
| Wal-Mart Stores | WMT | NYSE | $54.40 | 1.23% | **$59.00** | BUY |
| Whole Foods Markets | WFMI | NASDAQ | $33.89 | 2.12% | **$40.00** | BUY |
| WisdomTree Dividend Top 100 Fd | DTN | NYSE | $53.11 | 3.85% | N/A | BUY |
| Xerox | XRX | NYSE | $15.10 | 1.06% | $19.00 | BUY |
| **Energy/Natural Resources** | | | | | | |
| Anglo-American PLC | AAUK | NASDAQ | $31.58 | 3.58% | $36.00 | BUY |
| EnCana | ECA | NYSE/TSE | $76.69 | 2.09% | **$82.00** | BUY |
| Icon Energy Fund | ICENX | 800-764-0442 | $31.41 | 31.15% | N/A | BUY |
| Plum Creek Timber | PCL | NYSE | $41.13 | 4.08% | $50.00 | BUY |
| Royal Dutch Petroleum | RDS.A | NYSE | $71.69 | 4.02% | $87.00 | BUY |
| Transocean | RIG | NYSE | $143.54 | 24.45%*** | **$155.00** | BUY |
| USAA Precious Metals & Minerals | USAGX | 800-862-6909 | $36.57 | 7.25% | N/A | BUY |
| **Aggressive Growth** | | | | | | |
| Comcast | CMCSA | NASDAQ | $20.29 | 1.22% | **$24.00** | BUY |
| Discovery Holdings | DISCA | Nasdaq | $20.80 | 0.00% | **$25.00** | BUY |
| Electronic Data Systems | EDS | NYSE | $17.59 | 1.14% | $24.00 | BUY |
| Ford Motor Convertible Pfrd. | F.PRS | NYSE | $30.58 | 10.63% | $41.00 | BUY |
| Icon Financial Fund | ICFSX | 800-764-0442 | $10.60 | 15.75% | N/A | BUY |
| Liberty Entertainment**** | LMDIA | NASDAQ | $24.86 | 0.00% | $29.00 | BUY |
| Liberty Global | LBTYA | NASDAQ | $35.14 | 0.00% | $45.00 | BUY |
| Maxim Integrated | MXIM.PK | NASDAQ | $20.40 | 1.89% | **$25.00** | BUY |
| The Prudent Bear Fund | BEARX | 800-711-1848 | $6.38 | 3.13% | N/A | BUY |
| Symantec | SYMC | NASDAQ | $17.34 | 0.00% | $20.00 | BUY |
| Time Warner | TWX | NYSE | $14.60 | 1.51% | $20.00 | BUY |
| Western Digital | WDC | NYSE | $28.37 | 0.00% | $33.00 | BUY |
| | | | | | | |

***Prices as of the market close on Friday, April 4, 2008***

***Yield represents all distributions during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.***

****Yield represents a one-time special distribution.***

*****Recently spun off*

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

was up 22%. But look at **Tetra Tech**, which specializes in environmental remediation, especially of water, and **Insituform**, which replaces large scale sewer pipes without tearing up roads and landscape. TTEK added 15.6% and INSU 17.7%. How about **Superior Industries**, a designer and manufacturer of auto parts, primarily wheelcovers, that jumped 20%? We're even reading that optimists believe Ford can not just survive the chaotic auto industry but become a leader. Last year, Ford was considered the weakest of the not-so Big Three. Now some are writing that Ford is the most able to dig itself out. Look at the April 7th issue of *Barron's*. We're not inclined to believe everything we read, but given how pessimistic the market remains about Ford, anyone who on our recommendation has bought the Ford Convertible Preferred (+2.2%) might be buoyed.

Other positions that had been lackluster surged: **Sara Lee** was up 15.2%. **Mattel** has suffered after recalls of toys produced for it in China, but is digging out of that hole, adding 11.7%. **Wal-Mart** is doing well as consumers penny pinch. It tacked on another 9.5%.

And then there is **Schering-Plough**, which a panel at the Chicago meeting of the American College of Cardiology poleaxed, declaring that Zetia and Vytorin (Zetia plus Zocor, a statin) were no more effective than statins alone in preventing the deposit of plaque. Regardless that the data, an imaging study of 720 subjects with genetically triggered hypercholesterol, is far from conclusive, the market responded as if Schering and its partner, Merck, would never sell another dose. At one point, the market priced SGP as if it were at risk of going out of business. This was and is nonsense.

Indeed, we think Schering even now that it has begun to recover from the panic lows, remains a bargain even were Zetia/Vytorin eliminated. There are other drugs coming from the pipeline of new products, and a few could be blockbusters. Nonetheless, SGP since the last letter is down 18.4%.

Are we crazy to remain unconvinced after an august panel of premier researches decided Zetia/Vytorin are not what the manufacturers claim? Medical research, especially when preliminary, is fallible. At the same session of the ACC that pilloried Schering, researchers reversed preliminary negative findings that suggested drug-coated stents were more dangerous than bare stents for heart attack patients. When the media last year first picked up that false result, shares of stent makers **Boston Scientific** and **Johnson & Johnson** were hit hard. BSX added 14.3% since the last letter, most of it leading up to and in the week after the ACC sessions. JNJ moved up 6.9%. One of the panelists from last year's session that had damned drug-coated stents apologized in the face of the more complete data: "Perhaps," he said, "we overshot." As we like to say, *Sound Advice* tends to buy other people's pessimism. When pessimism mutates into panic—and we firmly hold a contrary opinion—it's time to buy.

## *TECH*

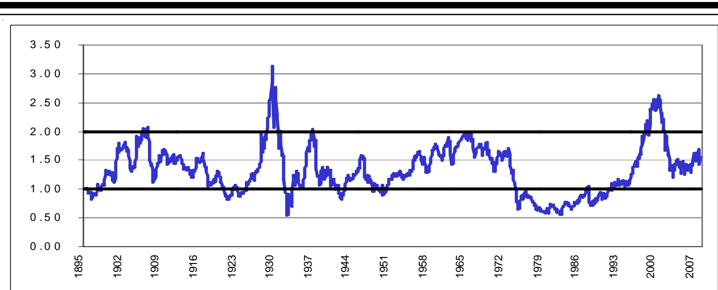
Given how well tech did this month, it's no surprise our positions prospered. **Maxim Integrated**, the mixed-signal semiconductor maker, added 11.5% as it gets closer to regaining inclusion on Nasdaq once it files the revised quarterly and annual reports that take into account past fraudulent option pricing. MXIM has had a very rough year, but we expect it to benefit from a recovery in tech as well from returning from its exile on the Pink Sheets. **Microsoft** has been bouncing around as Wall Street tries to handicap how likely its bid for Yahoo! is to succeed. The rationale for MSFT's bid is a need to bulk up its Internet presence in a battle with Google. Critics of such a deal believe Microsoft would do better returning cash to shareholders and use its existing weapons to compete. Since the last letter, MSFT is up 4.2%. **Symantec** added 2.4%.

We had praised **Western Digital** recently for outpacing hot names like Google, but the shares got hit by concern over too many disk drives, an issue that pops up annually at this time of the year. We believe it will pass. WDC is off 6.3%. Soft-tech names like **Xerox** (+9.2%) and **Electronic Data** (+5.3%) prospered, perhaps suggesting that some investors are looking beyond current economic weakness. As is the case with old economy companies like Fastenal, Superior, Tetra Tech and Insituform, it is possible we are seeing early value buyers who are willing to buy before they have any conclusive evidence of a turn coming in the economy. We're always willing to do that, since by the time it becomes clear that the economy is rebounding, the best part of the profits will have been made. ***SA***

# Sound Advice Market Indicators for March 2008

**The Diffusion Index of Lagging Indicators** gives “Sell” signals when all of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. Currently 50 percent of the indicators is above its level of six months earlier.

**The Diffusion Index of Leading Indicators** gives “Buy” signals when its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates. The latest reading came in December 2005 as a "Buy". Currently 100 percent of the indicators are above their level of six months earlier.




**The Risk Indicator** tracks supercycles in stocks by comparing prices of stocks to real estate (house prices). A reading above 2.0 indicates times when stocks are extremely high relative to real estate. These are times when the risk is high and a supercycle is approaching a zenith. Conversely, a reading below 1.0 indicates stock prices are extremely low relative to real estate. At these times, the upward phase of a new supercycle is beginning. The current reading stands at 1.53.

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. Between each “Buy" signal and each “Sell" signal, the S&P 500 rose substantially without exception. The average gain was 31.1 percent, not counting dividends. On an annualized bases the gain was 16.4 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

| Buy Signals Date | S&P 500 | Sell Signals Date | S&P 500 |
|---|---|---|---|
| | | Feb-69 | 101.50 |
| Sep-69 | 94.51 | May-73 | 107.20 |
| Nov-74 | 71.74 | Aug-77 | 97.75 |
| Jan-81 | 132.97 | Dec-83 | 164.36 |
| Sep-85 | 184.06 | Oct-87 | 280.16 |
| Mar-89 | 280.00 | Sep-89 | 347.33 |
| Oct-92 | 415.10 | Jan-95 | 464.72 |
| Feb-97 | 798.38 | Sep-99 | 1,383.60 |
| Feb-03 | 841.15 | Jul-05 | 1,234.18 |
| Dec-05 | 1,248.29 | | |

During the intervening periods between “Sell" signals and “Buy" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased a paltry 0.82 percent per year, a return that could have easily been beaten many times over with safe investments such as Treasuries, short-term bonds or other low-risk investments.

To assess whether a market crash is likely after a "Sell" signal, we turn to the Risk Indicator. If the Risk Indicator is close to or above 2.0, we know the market is relatively high and contains a high degree of risk. This was indeed the case in September 1999 when the Diffusion Index of Lagging Indicators flashed a “Sell" signal and the Risk Indicator was (substantially) above 2.0. The peak came in six months, marking the end of the bull market as well as the peak of Supercycle Five. The market subsequently crashed. The S&P 500 dropped 39 percent until the next “Buy" Signal was given by the Diffusion Index of Leading Indicators in February 2003 (which was the exact month that bear market low point was reached). During that decline, most stocks suffered greater losses. The NASDAQ dropped nearly 80%.

Conversely, the market does not suffer lasting declines after “Sell" signals when the risk level is low. For example, the “Buy Signal” in November 1974 was one month from the bottom of that bear market, and came at a time when the Risk Indicator was below 1.0. Consequently, this “Buy" signal also marked the beginning of Supercycle Five. As the upward phase of Supercycle Five ensued and the Risk Indicator remained relatively low, the market did not experience lasting downturns after “Sell" signals. Instead, the bull run was merely interrupted with short declines, sideways movements, and sometimes even advances. Even the three-day decline in October of 1987, which became known as the “Crash of 87”, was followed by a stampede of buyers snapping up bargains. I remember seeing individual investors lined up to invest outside discount brokerage offices because the phones were logjammed with buyers.

However, as previously noted, when Supercycle Five reached its peak and the Risk Indicator climbed above 2.0, the decline was severe after the September 1999 “Sell" signal due to the excessive heights to which prices had previously been propelled.

We use the ***Sound Advice*** Market Indicators to influence our approach and nature of our recommendations. When “sell” signals are in force, our recommendations are more defensive in nature. We will be looking for special situations and are likely to recommend taking profits more readily. Conversely, during “buy” signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market averages (more than double the profits from the S&P 500 since 1/1/2000). ***SA***

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