

## Transocean's Turnaround



New subscribers often ask, "How much should I allocate to each recommendation in the Sound Advice portfolio?"

Our statistics are based on the assumption that \$10,000 is invested in each position. When a new position is added, we assume the same \$10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, we assume another \$10,000 is invested again in that position.

If you are investing in the portfolio for the first time, we believe your performance will be enhanced by deferring purchases in positions that are not in our "Buy" zone; see the table on page 9 which is updated with live pricing on our website:

[www.soundadvice-newsletter.com](http://www.soundadvice-newsletter.com).

We understand Hulbert uses the same method for tracking our performance for specific periods.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table on page 9 divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

**-Gray Emerson Cardiff**

In our mid-issue blog, we recommended purchasing Transocean LTD, the world's largest offshore drilling contractor and supplier of deep-water platform drilling rigs. Its ticker symbol is appropriately "RIG". At close to 10 times earnings, RIG is extremely undervalued and has considerable potential for capital gains.

Whether or not the most recent conflict in Iraq will lead to a compromise in oil supplies, that geopolitical event has brought attention to the entire oil services industry and has brought life back into the entire sector. Outside of Iraq, the offshore drilling business has definitely recovered, and is actually booming according to many industry specialists who claim that more oil will come from offshore than from inland fracking and drilling.

In a recent conference call, Transocean's President and CEO Steve Newman said, *"We remain very bullish on the long-term fundamentals available to deepwater business premised on a growing demand for energy and a belief that a majority of this new energy demand will be satisfied by hydrocarbon sourced from deepwater and harsh offshore environments."*

### Why so Undervalued?

The oil disaster that occurred in the Gulf of Mexico in 2010 happened on Transocean's "Deepwater Horizon" drilling platform while it was on lease to British Petroleum (BP). Under the typical business arrangement, Transocean was indemnified by BP, but it was still fined \$1.0 billion under the Clean Water Act. Transocean also paid \$400 million in other settlements. To add context, Transocean currently receives approximately \$9+ billion of annual revenues. While final litigation is not completely over, further financial settlements are not likely to be relatively large.

The Gulf accident cast a pall over the entire drilling industry. Immediately after the accident, RIG dropped down into the low \$40s and then recovered briefly to above \$80 by early 2011. However, the slowdown in drilling in the wake of the accident caused an oversupply in drilling platforms which led to a decline in rental rates for drilling platforms. Since 2012, rental rates for drilling platforms have remained stagnant at approximately \$600,000 per day, down from peak levels of \$750,000 per day. RIG has since been in a trading range, from the low \$40s to the upper \$50s, with three quick dips below \$40.

### Following Carl

In 2013, Carl Icahn purchased \$1.15 billion of RIG. Evidently he saw the improving financial condition. After losses of \$5.7 billion in 2011 and \$219 million in 2011, Transocean turned the corner in 2012 and has since been becoming increasingly more profitable. In late 2013, Icahn launched a proxy battle demanding cost cuts to increase margins, which is now happening. The most recent first quarter 2014 earnings were \$1.43 per share, which was substantially above expectations, versus \$0.94 one year ago.

Rig currently has a backlog of orders for platforms worth close to \$26 billion. During the last 18 months, RIG added 3 newly built drilling platforms to its

portfolio. It is also delivering 2 new platforms later this year called the Deepwater Asgard and the Deepwater Invictus. These two platforms will add to revenues as they come on stream.

RIG also has 5 new drilling platforms under construction which are being financed by long-term contracts with major customers including Shell and Chevron. In February, RIG pushed the button on constructing two more ultra-deepwater platforms that are scheduled for delivery in the second quarter of 2017 and the first quarter of 2018.

Carl's proxy battle also called for a hike in the dividend, which was increased in May from \$2.24 to \$3.00. Fifteen percent of the dividend is withheld as a Switzerland tax. We understand that the 15 percent can be recouped by US individuals by claiming a foreign tax credit on annual tax returns. Even forgoing the 15 percent withholding, the net dividend after the withholding is \$2.55 for a yield of 5.7 percent. Recouping the dividend brings the yield to 6.7 percent.

Most importantly, included in the proxy battle was for Transocean to spin off some assets into a master limited partnership (MLP), following the strategy implemented by one of its closest competitors, Seadrill (SDRL).

Investors in MLPs holding steady income-producing assets are satisfied with 6-7 percent yields these days. This means assets can be sold, or "dropped down", to MLPs for the equivalent of close to a 15 price/earnings (P/E) ratio. (This also happens to be in line with current P/E of the overall stock market.) The drop-down price is often a large premium to the acquisition cost being carried on the books.

Seadrill formed an MLP in 2012, called Seadrill Partners, and has since dropped down 9 rigs to it. During the first quarter alone, 5 assets were dropped down to the MLP for close to \$1.25 billion, unlocking the full value of assets held on the books at \$355 million. The cash injection from the drop-down immediately improved Seadrill's balance sheet and provided capital for constructing new drilling platforms which rent for substantially higher day rates.

### Transocean's Drop-Downs

Transocean announced the formation of its first MLP in late June, called Transocean Partners, which it plans to fund with an initial public offering (IPO) of \$350 million. Initially, a 51% interest in three assets located in the Gulf of Mexico will be dropped down into Transocean Partners; two ultra-deepwater drillships which are leased to Chevron and one semi-submersible rig leased to British Petroleum (BP).

Transocean has also announced plans for a second MLP called the Caledonia Offshore Drilling Company, to which it will drop down 8 of its rigs operating in the North Sea. These are the oldest rigs that Transocean owns and the drop-down will improve the average age for the balance of the fleet which has been another factor dampening the value of RIG. The fact that these are in the North Sea means that competition will be limited by stringent regulations that create a barrier to entry. In addition, rigs capable of drilling in the stormy North Sea earn higher rental rates than those in the Gulf of Mexico.

As in the case of Seadrill, the creation of MLPs will be highly beneficial to Transocean. The cash infusion will bolster its balance sheet and provide a way for the company to sell assets at full value, at the equivalent of close to 15 times earnings, while still maintaining control of these assets.

Many of these rigs have long-term contracts with substantial companies, making them ideal for MLP investors who are looking for higher income than typically available elsewhere.

### Risk/Reward

At the low end of its 2-year trading range with a recently-increased dividend, RIG presents an excellent risk/reward ratio right now. The risk is low because the recently-increased dividend puts a floor under the stock. A high dividend limits downside exposure because a decline in the stock price will raise the yield even more.

The profit potential is high because at 15 times current earnings, RIG belongs in the vicinity of \$65 a share, nearly 50 percent higher than it is today. As the industry strengthens and rental rates begin rising again for drilling platforms, RIG is bound to break out of its current depressed trading range.

### The "No-Brainers"

The ETFs we are recommending, designed to benefit from rising long-term Treasury bond yields differ in the amount of leverage used:

The [Direxion Daily 20 Plus Year Bear 3 Shares \(TMV\)](#) uses 3:1 leverage.

The [Proshares Ultrashort Lehman 20 Plus Year Treasury \(TBT\)](#) uses 2:1 leverage.

The [Proshares Short 20 Plus Year Treasury \(TBF\)](#) uses no leverage.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance.

We have dubbed these ETFs as "No-Brainers" because

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interest rates always rise after a recession during the recovery. The upward path has never been smooth, and this time is proving to be no exception. Since the first of the year, the sluggish economy has pulled down long-term bond yields. However, we see continued signs of economic recovery, including those for May, the latest month reported.

Industrial production rose 0.6 percent, Manufacturing output increased 0.6 percent, the output of mines gained 1.3 percent, and total industrial production was 4.3 percent above its level of a year earlier. The Housing market continued to be strong, and consumer confidence reached a 6-year high.

In addition, the capacity utilization rate for total industry increased 0.2 percentage points to 79.1 percent. Several

credible studies agree that when utilization rises above 80%, increases in producer prices will begin rising and lead to increases in inflation.

We can also correlate long term Treasury bond yields to the capacity utilization rate. Take a look at the two graphs below. They are lined up by year with 30-year Treasury bond yields on top and capacity utilization below. The shaded areas on the capacity utilization graph show periods of recession, during which capacity utilization drops. However, after recessions the capacity utilization rate rises above 80 percent. Note that during the times when capacity utilization is above 80 percent, 30-year Treasury bond yields are above 5 percent – sometimes substantially above 5 percent.

## 30-Year Treasury Bond Yields



## Capacity Utilization



### The Impact of Tapering

The Federal Reserve's Quantitative Easing (QE) program has been keeping bond yields artificially low by purchasing \$85 billion of Treasury securities each month for the last several years. However, the Federal Reserve is in the process of tapering these purchases by \$10 billion per month and this will drastically alter the demand side of the equation.

At the risk of repeating ourselves, it is important to put the elimination of the QE program into perspective.

At the beginning of the year, before the Federal Reserve starting tapering its monthly purchases, it held \$2.2 trillion in Treasury securities. In second place is China, whose holdings total \$1.27 trillion. Running in close third place is Japan, which owns \$1.2 trillion. In a distant fourth place is Belgium with \$318 billion (\$0.318 trillion), and the rest of the world's countries follow with smaller holdings.

QE purchases will be completely tapered by September. That means \$1.02 trillion of annual buying will be gone, which is equivalent to 80 percent of China's entire inventory of US Treasuries. China, along with the Federal Reserve, is also trying to reduce its dependence of US Treasuries and has become a net seller. Since November, China has reduced its inventory by approximately \$45 billion.

### The Timing

In June, the latest reading on the inflation rate was 2.1 percent over the 12 months ending in May. That is a magic number because the Federal Reserve Board's tolerable inflation rate in 2.0 percent. One month's reading is unlikely to push the Federal Reserve into dramatically changing its monetary policy, but a continued trend will. The latest 2.1 percent follows 1.6 percent in May and 1.1 percent in April.

As we approach that inflation rate, along with continued improvement in other economic indicators, we can be sure that today's interest rates and bond yields will not last.

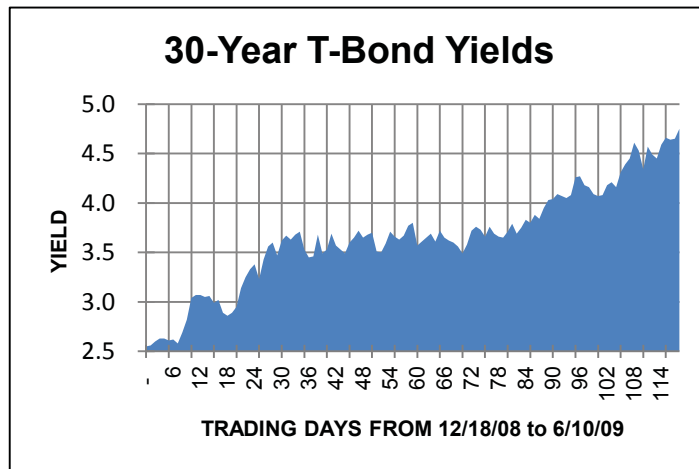
Our Diffusion Index of Lagging Economic Indicators (page 11) has been hitting 100 percent in recent months which tells us that the economy is now strong enough to push up interest rates.

We also know that long-term Treasury bond investors normally require a real rate of return of 3 percentage points above the rate of inflation. That means the 30-year Treasury bond should be yielding close to 5.0 percent right now.

It is hard to imagine that 30-year bond yields will remain at current levels much longer.

### The Model

The most recent time long-term Treasury bond yields rose significantly was from December 18, 2008 to June 10, 2009, (118 trading days) when we had a mild and short-lived recovery. Yields on 30-year Treasury bonds rose from 2.55 percent to 4.75 percent, or 220 basis points. The chart below shows the pattern.

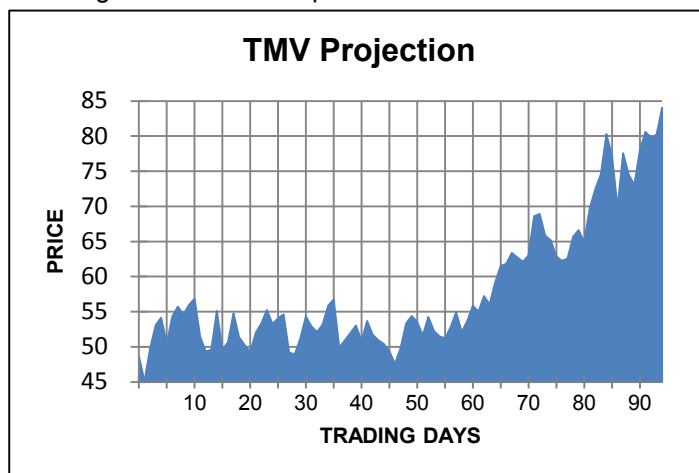


Our No-Brainer ETFs did not exist during this entire period, so we don't have historical track records to view. However, we know how these ETFs work, and can model them to get an idea of the profit potential.

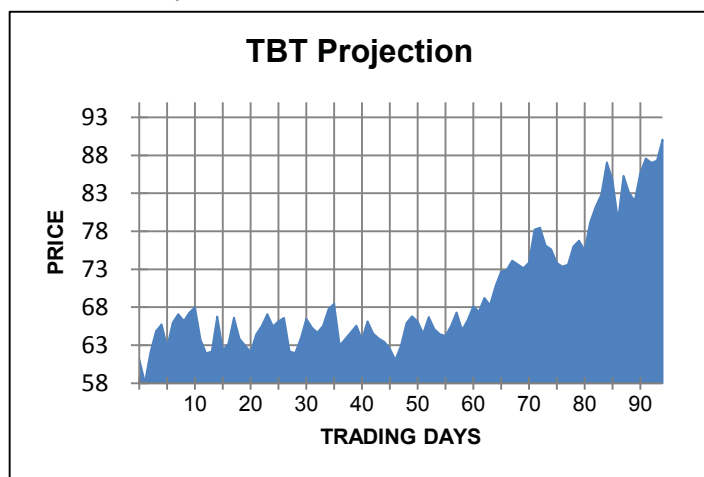
The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds with an average maturity length of close to 27 years. The prices of our No-Brainer 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.

To construct our models, we start with a projection of an increase in 30-year Treasury bond yields. A conservative approach would be to assume that long-term Treasury bond yields will not rise beyond 4.75 percent -- not any higher than the last peak. We can use the pattern of the last 95 days of the 220 basis point rise when yields rose from today's yield of 3.37 percent to the peak of 4.75 percent. In that scenario, our No-Brainers would rise to the following levels:

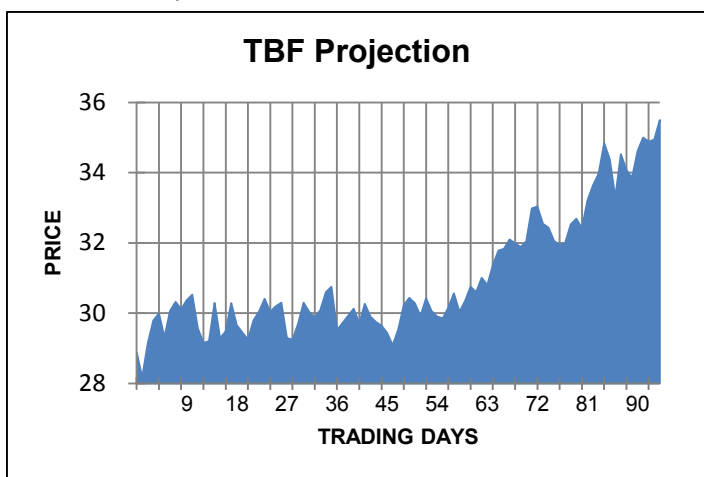
**TMV** would climb to \$84, for a 72 percent gain. The following chart shows the pattern.



**TBT** would climb to \$90, for a 47 percent gain. The following chart shows the pattern.



**TBF** would climb to \$35.5, for a 23 percent gain. The following chart shows the pattern.



While the pattern of today's rise is unlikely to be exactly the same as the previous rise, a 4.75 percent yield serves as a reasonable target. After yields rose to 4.75 percent on the last rise, the economy was considerably weaker than it is today and subsequently went into a decline.

We continue to note that a target of 4.75 percent does not require a full recovery to the inflationary stage of the business cycle. Our objective is only for Treasury bond yields to recover to normal levels, to the vicinity of 4.75 percent, from the artificially low yields caused by the 2008-09 economic meltdown and the subsequent massive bond purchases under the Federal Reserve's unprecedented Quantitative Easing programs.

## Portfolio Updates

Here are updates on the rest of our recommendations in alphabetical order. The table on page 9 details our buy limits and other information on each recommendation, and organizes them by investment objective. Also see our website for live pricing.

**Agrium (AGU)** is up 2.1 percent this year, extending our profit to 707 percent. AGU has a broad mix of agricultural products

and services that are poised to benefit from growing demand as arable land continues to disappear around the world and the need for higher food production per acre increases. Growth is also bolstered by an expanding worldwide population along with increasing per-capita income.

Agrium's potash fertilizer has been falling in price during the last 18 months. Although this in a relatively small source of revenues, it has caused a drag on AGU's stock price. However, there are indications that the potash market is stabilizing. Potash production is down 15 percent during the last year and continued to decline in May, resulting in two months of upticks in the price.

AGU has a solid dividend yield and is undervalued at 10 times the expected 2015 earnings of approximately \$9.00.

**AMN Healthcare (AHS)** is down 16 percent this year, trimming our profit to 133 percent. AMN Healthcare provides temporary healthcare staffing services to the healthcare industry, ranging from nurses to physicians. We recommended this stock at an average price of \$5.35 based on the rationale that it was a two-fer. AHS was not just an opportunity to invest in healthcare, which is traditionally a non-cyclical industry, but it was also a chance to buy into a healthcare business that would benefit from a recovery in the economy.

As our growth forecast was panning out, the stock advanced sharply in 2013. As its price/earnings (P/E) ratio expanded above 20, we recommended holding off on purchases. Since then, the stock price has been slipping.

AHS dropped back into our buy range in May. Growth should be bolstered by the Affordable Care Act which is expected to drive greater demand for clinicians.

In addition, as the newly insured begin to utilize healthcare services, temporary staffing volumes are expected to increase again.

**Associated Estates Realty Corp (AEC)** is up 15 percent so far this year, extending our gain to 31 percent. What originally attracted us to AEC was the fact that it was selling at a substantial discount to the value of its net assets, and it paid a nice dividend. Although AEC has since risen in price, so has the value of its real estate portfolio. It remains a stellar value with a nice dividend of 4.2 percent.

We value the equity of AEC's apartment portfolio at \$28.45 per share, approximately 40 percent greater than the current stock price.

**Boston Scientific (BSX)** is up 6.2 percent so far this year, extending our profit to 34 percent. BSX's medical products are well suited for an aging population in the US. The Company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs.

**Chesapeake Energy (CHK)** is up 12 percent this year, extending our gain to 85 percent. CHK is the second largest producer of natural gas and pioneered the use of fracking

technology to produce oil liquids and natural gas from shale. We added CHK to the portfolio because it was at a substantial discount to its net assets. The stock price was cheap because of low natural gas prices, poor corporate governance, and because it was in the midst of a financial squeeze. We could see all of these conditions were likely to be remedied, and indeed they were.

CHK's operating results are strengthening due to increases in production and cost reductions from its most significant assets, including Eagle Ford Shale in South Texas, its mid-continent assets, and its Utica and Marcellus Shale operations in Ohio, Pennsylvania, and West Virginia.

Value Line's fair value estimate of CHK is \$38 which is well above the current stock price.

**Commonwealth REIT (CWH)** is up 16 percent this year, extending our gain to 29 percent. We originally introduced CWH when it was selling for close to a 50 percent discount to its NAV. Subsequently, two large investors, Corvex and the Related Companies, woke up shareholders and sponsored a proxy vote to remove the entire board and management.

Sam Zell is now chairman of the board and should be improving the management of CWH's assets.

Based on the latest financials, we currently value CWH stock at approximately \$32.50 per share, which is still substantially above the current stock price. As a confirmation of our valuation, Corvex/Related has contended the stock is worth more than \$40 per share with better management.

**Fidelity Select Natural Gas Fund (FSNGX)** is up 23 percent this year, extending our gain to 46 percent. This fund concentrates on the natural gas industry, and it is a diversified play on the gap between the energy equivalents of oil and natural gas.

Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other

sources of energy, which translates into an inexorably vibrant and expanding natural gas industry.

One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. With one barrel of oil at \$100, that is the cost of 5.8 million BTUs of energy. On the other hand, with a market price for natural gas at \$5.00 for one million BTUs, 5.8 million BTUs will cost \$29 (5.8x\$5). So the same amount of energy is available for 29 cents on the dollar -- if it is in the form of natural gas.

To illustrate the point, we continue to display the historic relationship between the costs of these two forms of energy in the chart above because it demonstrates that today's disparity is not a normal situation.

The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Note that for most of the time (36 years), the two forms of energy are closely aligned.

**Freeport-McMoRan Copper & Gold (FCX)** was originally added to the portfolio in late August at \$30.42 per share. FCX is up 20 percent since we recommended it.

Copper is woven into the fabric of every developed economy, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. In March 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. As the world's economies continued to expand into 2008, so did FCX.

Since the Phelps Dodge transaction, FCX has added substantially to its copper reserves and continues to have opportunities to add reserves because of its large resource base and ongoing exploration program.

The 2013 acquisition of substantial oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico is an added bonus both for earnings growth and stability. Growth in earnings is ahead and the dividend yield is attractive, plus it reduces risk.

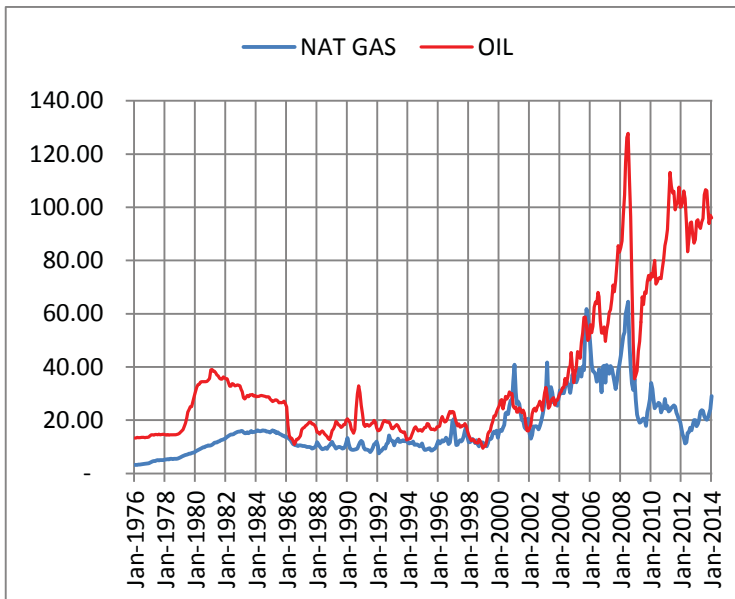
**Hambrecht & Quist Life Sciences Fund (HQL)** is up 4 percent this year, extending our profit to 134 percent.

We have been recommending this Fund because the most explosive profits in the entire healthcare industry can be found in biotech companies.

In 2013, the worldwide sales of six of the top ten drugs were of biotechnology origin. Approximately 75% of companies in the NASDAQ Biotech Index (NBI) had 2013 revenues of \$10M or more. This compares to ten years ago when the majority of NBI companies were "story" stocks with no significant earnings and whose future depended on the potential success of their products. The consensus of analysts is that earnings growth in the biotech sector will exceed that of nearly all other sectors of the economy.

HQL's largest position is Gilead Sciences, the inventor of *Sovaldi*, a drug that cures Hepatitis C. In its early launch, the drug is on track to be the most successful drug ever.

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



During the six month period ending March 31, 2014, the FDA approved significant drugs among HQL's holdings. In additions to Gilead's *Sovaldi* in Hepatitis C, the FDA approved Celgene's *Otezla* for psoriatic arthritis, as well as Biogen's *Imbruvica* for chronic lymphocytic leukemia.

There was also positive clinical data for Biogen Idec's *Isis-smnrx* for spinal muscular atrophy, Medivation's *Xtandi* in pre-chemotherapy prostate cancer, as well as positive clinical data for Gilead's PI3K drug *Idelalisib* in both indolent non-Hodgkin's lymphoma and chronic lymphocytic leukemia, along with Amgen's and Regeneron Pharmaceutical's antibodies targeting PSCK9 for cholesterol metabolism, and Puma Biotechnology's *Neratinib* in breast cancer.

There was also significant progress in HQLs less-established, emerging holdings. Of note was Sangamo BioSciences' recent clinical data demonstrating the use of its technology to effect a relatively durable "cure" of HIV in a specific patient population.

There were, as usual, unfavorable events among HQL's holdings. The most significant was the identification of cardiovascular and other side effects associated with the use of ARIAD Pharmaceutical's *Iclusig* drug in hematologic cancers. The future of Amarin's *Vascepa* for abnormally high triglyceride levels also became doubtful.

While positive events outweighed negative ones, we as investors can never be sure exactly which will be the winners. The normal occurrence of disappointments underscores the need for diversification in the biotech industry, which is why we recommend an aggressive but diversified fund such as HQL.

**Hersha Hospitality (HT)** is up 21 percent since our recommendation in December 2013. Our principle reasons for recommending HT was because hotel assets in general are sensitive to the business cycle and will benefit strongly from the economic recovery.

In addition, the price of the stock is depressed and selling at a discount to its net asset value because many of its major properties have been undergoing renovations, and the income potential has not yet been realized.

Based on the most recent first quarter financials, we value HT's NAV at \$7.33 per share, which is substantially higher than the current price of the stock. We expect to see further increases of NAV in the immediate quarters ahead as income from new acquisitions are realized along with increased income from completed renovations.

In early June, Hersha opened its brand new 205-room Hilton Garden Inn Midtown East, on 52nd Street just off Third Avenue in New York and will be adding to earnings. In May, HT announced first quarter funds from operations (FFO) of \$11.6 million, an increase of \$3.5 million (43 percent) despite the unusually cold weather.

HT has an excellent risk/reward ratio. Risk is minimized with the stock below a currently depressed net asset value. The dividend is solid because it is well-covered by funds from operations (FFO). The yield is attractive and limits downside movement in the stock price.

**ICON Energy Fund Class S (ICENX)** is up 13 percent since we added it to the portfolio last year. Demand for energy accelerates with an economic expansion, and we expect to see solid gains as the economic recovery gains traction. It takes energy to make everything, and especially large amounts to make the most vital materials and substances, such as chemicals, plastics, and to run data centers. The best time to invest is when the economy is coming out of a slump, before demand increases.

Aside from the cyclical timing, above average investment returns can be earned over the long run. Over the last 10 years, the Energy Equity Index has produced superior investment returns to that of the S&P 500. That performance is because energy is in the fabric of the economy.

Most energy mutual funds have not been able to match the performance of the Energy Equity Index. However, this fund not only beat the Energy Equity Index resoundingly, it has turned in the best performance – by far – of all energy funds.

ICON management looks for changes within the energy industry to capture value, rather than simply depending on rising prices. Management points out that it has achieved growth even during periods of declining energy prices. The track record of this fund bears this out.

**Pfizer (PFE)** is down 1.4 percent this year, trimming our profit to 85 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on its blockbuster drug, *Lipitor*. However, its future was brighter due to the arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage.

In June, Pfizer signed a deal with French biotech company, *Collectis*, to develop a variety of cancer immunotherapies that have the ability to use single-donor engineered T-Cells for multiple patients.

Also in June, Pfizer submitted an application to the FDA for its vaccine candidate to treat invasive meningococcal disease which is difficult to diagnose and has a high mortality rate.

The June 19 issue of *The New England Journal of Medicine* published the results of a 24-month study that showed Pfizer's drug *Xeljanz* inhibited the progression of rheumatoid arthritis, and can be used on patients who have had an inadequate response or intolerance to methotrexate.

**Retail Opportunities Investment Corp (ROIC)** is up 9.6 percent this year, extending our profit to 55 percent. This REIT began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains.

ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. During 2013, ROIC acquired ten grocery-anchored shopping centers for \$368 million. Funds from operations (FFO) increased during the year as these properties were added.

ROIC hit the ground running in 2014 by purchasing \$112 million in shopping center acquisitions in the first quarter.

In June, ROIC announced the purchase of Fallbrook Shopping

Center in an affluent community of California for \$210 million which management says will add to earnings immediately. This is a relatively significant acquisition for ROIC and will be one of their flagship properties. Fallbrook fits ROIC's model as a center anchored by supermarkets, especially as Fallbrook has three: Ralph's, Trader Joe's, and Sprouts Farmer's Market.

Also in June, ROIC had a public offering of 14,375,000 shares of common stock, the proceeds of which will be used to reduce the Company's \$350 million unsecured revolving credit facility which will counter-balance the dilution caused by the additional stock.

As new properties are added, along with tenant upgrades, FFO is bound to continue to rise, along with the dividend, and push the price of this REIT upward. Meanwhile, ROIC pays a 4+ percent dividend that lowers its risk profile.

**Stryker (SYK)** is up 12.5 percent this year, extending our profit to 105 percent.

SYK is best known for its orthopedic devices for artificial knees and hips. SYK also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase, and obesity trends continue, more and more hip, knee, and spinal procedures will be needed.

Stryker's cash-rich balance sheet with \$4 billion of cash and marketable securities, along with its robust cash flow, gives SYK multiple avenues for continued growth through acquisitions.

Recent acquisitions include Pivot Medical which provides SYK with a platform of arthroscopic implants to efficiently access the hip with minimal incision. SYK also recently acquired Berchtold Holding, which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems.

The MAKO Surgical acquisition put SYK in a leading position for robotic-assisted surgery and the potential for break-through innovations.

The 2013 purchase of Trauson Products, China's largest manufacturer of orthopedic implants, also offers access to the Chinese market and broadens SYK's customer base.

**Symantec (SYMC)** is down 2 percent this year, trimming our profit to 41 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. If there ever was a more certain growth industry, protection from cyber espionage is it.

We have been recommending SYMC because it is

undervalued. Recent "sum-of-the-parts" valuations range from \$25 to \$28 per share, a premium over the current price of the stock.

Symantec's latest innovation in mobile device management integrates threat-protection for both browser applications and email into one utility that provides protection from viruses, malware, freeware, fraudulent websites, and privacy risks.

**Tetra Tech (TTEK)** is down 2 percent this year, trimming our profit to 77 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet with \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. The latest contract came in June from the FAA's Office of Security and Hazardous Materials for \$76 million.

There is plenty to clean up domestically, and the greatest growth potential continues to be outside the United States, especially in China and India, where environmental concerns have been an afterthought. As these and other governments around the world make this a priority, Tetra Tech should be a prime beneficiary.

TTEK also provides energy efficiency and carbon management consulting which are bound to see growth under the new proposed carbon rules announced by the EPA in June which are aimed at reducing carbon emissions from power plants by 30

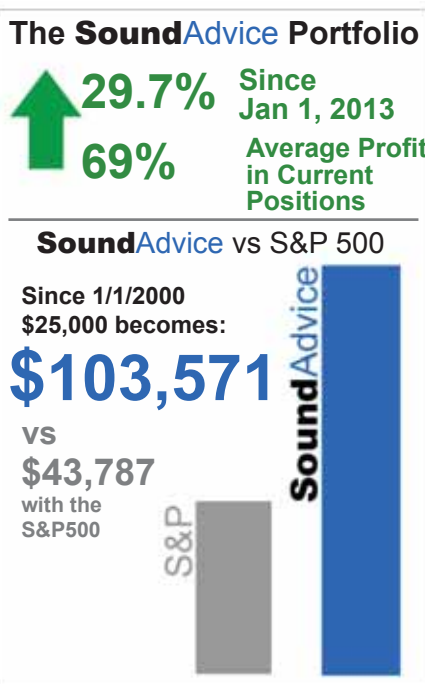
percent by 2030.

TTEK initiated its first quarterly dividend of 7 cents per share for the second quarter and is buying back \$100 million of its common stock.

**Third Avenue Funds** are in our portfolio because 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).

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 11.7 percent. It has led the pack of all real estate mutual funds during the last 3 years. This is still where the best real estate values can be found in a mutual fund. It is replete with stellar values substantially below NAV with strong growth prospects.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 18.08	4.20%	\$ 19.50	BUY
CommonWealth REIT	CWH	NYSE	\$ 26.48	3.78%	\$ 28.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 6.74	3.56%	\$ 7.50	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 15.84	3.79%	\$ 17.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.68	2.08%	\$ 33.00	BUY
Diversified Growth						
Pfizer	PFE	NYSE	\$ 29.67	3.51%	\$ 32.00	BUY
Stryker Corp.	SYK	NYSE	\$ 83.97	1.26%	\$ 87.00	BUY
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 28.66	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 12.51	2.00%	\$ 13.50	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE	\$ 91.89	3.26%	\$ 100.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 30.40	1.15%	\$ 32.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 45.93	0.72%	\$ 47.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 36.07	3.47%	\$ 37.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 24.76	2.99%	\$ 27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 27.26	0.00%	\$ 27.50	BUY
Transocean *	RIG	NYSE	\$ 44.53	5.73%	\$ 49.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 16.64	0.12%	\$ 18.00	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$ 12.36	0.00%	\$ 12.00	HOLD
Boston Scientific	BSX	NYSE	\$ 12.76	0.00%	\$ 14.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 48.72	0.00%	\$ 62.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 28.89	0.00%	\$ 32.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 61.13	0.00%	\$ 71.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 20.42	0.00%	\$ 25.00	BUY
Symantec	SYMC	NASDAQ	\$ 22.77	2.64%	\$ 22.00	HOLD

Prices are as of 6/27/2014. See our website for live pricing and buy limits: <http://www.soundadvice-newsletter.com/members>  
Yields on funds may include capital gain distributions. \* RIG yield is net of the 15 percent of Swiss foreign withholding tax.

Three months ago, we introduced the **Third Avenue Small-Cap Value Investor Fund (TVSVX)** which invests in companies with small capitalizations using the same value-oriented approach. It is up 3.1 percent so far. 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.

**USAA Precious Metals & Minerals Fund (USAGX)** is up 30.1 percent this year. When the economic recovery gets more traction, the money created in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities including precious metals. This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is the top-performing fund, and

has constantly out-performed precious metal equities for ten years.

**Xerox (XRX)** is up 4 percent this year, extending our profit to 48 percent. We have been recommending XRX because it has been transforming from purely a seller of printers and copiers to a company providing services on those machines along with developing information technology (IT) services. In 2013, the strongest growth came from the expansion into IT services, especially in the healthcare industry where technology is needed to reduce costs. In 2013, business processing outsourcing (BPO) revenues represented 57 percent of the company's total revenue.

During the last three years, XRX has repurchased \$816 million of its stock annually. Free cash flow continues to be strong. Management indicates that it will use some of its free cash flows to continue to buy back more stock in 2014 close to that average, and that beyond 2014, XRX plans to repurchase another \$1.0 billion of its stock.

At close to 10 times earnings, XRX is undervalued. XRX recently raised its dividend to \$0.25 annually.

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

## Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool the **SoundAdvice** "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings

and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the **SoundAdvice** Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the **SoundAdvice** Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$11.5 million in stocks and to \$1.43 million in houses.

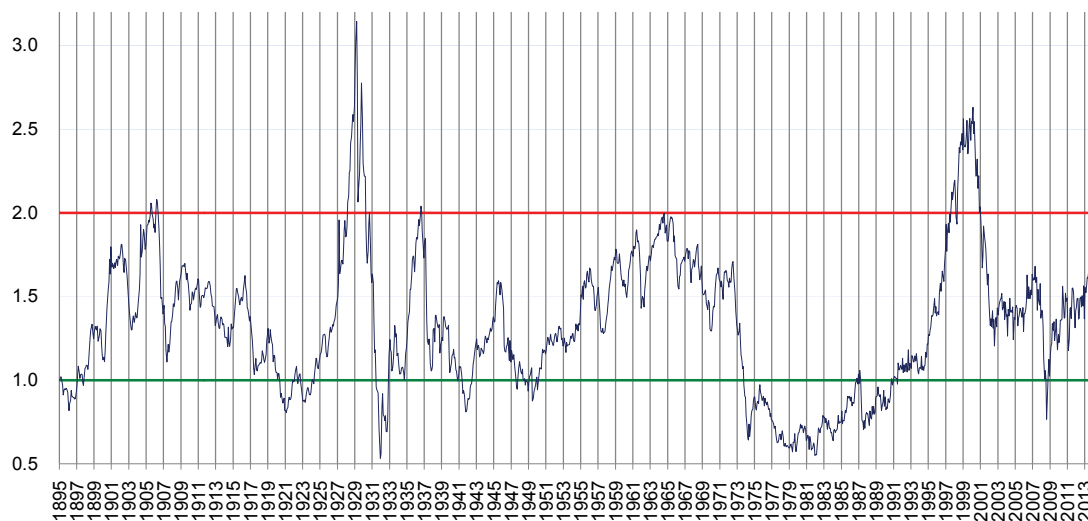
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the **SoundAdvice** Risk Indicator he would have made \$458 million, or 39.7 times more 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 1.75. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See **The Science of Making Money in Turbulent Markets** for a complete explanation of the **Sound Advice** Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you re-new your subscription.)



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

If the Supercycles identified by our Risk Indicator are the solemn, inexorable seasons that roll across the market's landscape, business cycles are the highly visible, sometimes serene but frequently blustery fronts and storms that we actually perceive as weather. The Risk Indicator has given us a reliable tool to determine the investment season in the stock market. This information is all-important; there will be no heat waves in January, no blizzards in July. But in our search for fair winds, we need to know more than the season. We also must be able to predict the shorter-term weather -- the bull and bear markets that fluctuate along the path of Supercycles.

The data we need is contained in the leading and lagging economic indicators published monthly by The Conference Board. We have hand picked the most sensitive of these economic indicators to produce our "Diffusion Indexes" which function with amazing accuracy as predictors of the birth of cyclical bull and bear markets in stocks.

To construct our SoundAdvice Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be  $(1.5)/3$  or 50 percent.

When the SoundAdvice Diffusion Index of Leading Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

**The SoundAdvice Diffusion Index of Leading Indicators:** As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 33.3 percent.

**The SoundAdvice Diffusion Index of Lagging Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which reveals that the economy is about to put upward pressures on interest rates, and to move to a cautious approach.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100% in again in April, 2014, based on the March data, again in May based on the April data, and again in June based on the May date. With the Quantitative Easing program winding down, this confirms our "Caution Signal".

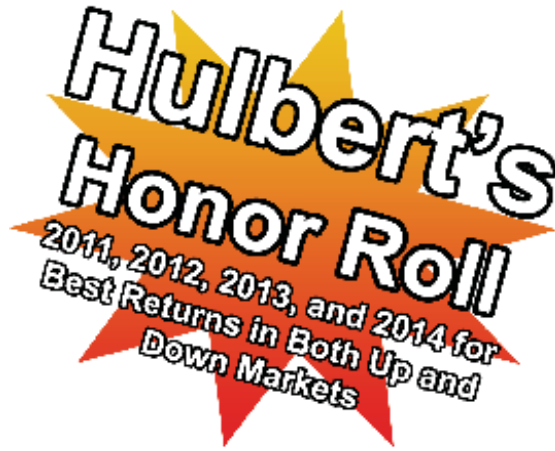
### Track Record of the SoundAdvice Diffusion Indexes

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 1.7 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Ave +/-	34.4%		1.7%

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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