



Waiting Our Turn

“Window dressing” continues to be part of Wall Street, a financial sleight of hand. At the end of each quarter, and especially at the end of the fiscal year, before reporting what they own to shareholders, many money managers flush underperforming stocks from their portfolios and replace them with those that had starred lately.

What’s the point? The window dressers’ losses already have occurred and the “profits” associated with the new shares belong not to the window dressers but to others. How dumb do these financial pros think their clients are?

When I was just getting into finance, I did not understand what window dressing accomplished. Not only did the new transactions create more costs but worse, these “professional” investors were selling low and buying high. Window dressing is a tacit monument to the manager’s real failure.

Now, after years in this business, the real purpose of window dressing is apparent. Justin Fox, in his admirable book, *The Myth of the Rational Market*, considers window dressing “a clear case of professional money managers taking actions—in an entirely rational effort to hold on to their jobs—that the hypothetical rational investor would not.”

It’s hardly surprising that Wall Street too often rearranges reality to provide a happier story. Consider mutual fund advertising that boasts dazzling performance but if you look more closely just happens to start at the last market low and fails to acknowledge what damage had happened before then.

There’s also “survivorship bias,” the financial equivalent of surgeons burying their mistakes. Fund families can put abysmally performing funds out of their shareholders’ misery by closing them and folding their withered assets into another fund. The nice thing is that the failed fund’s underperformance vanishes when calculating the performance of the merged funds.

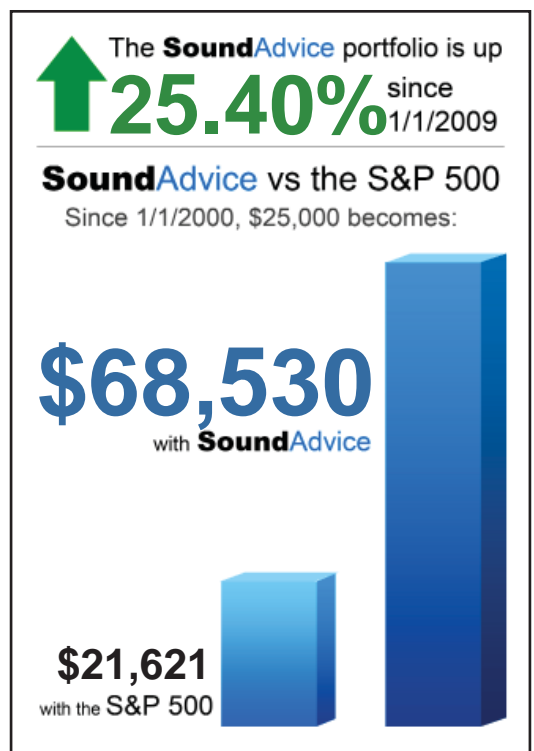
Just remember: Wall Street, at least at the retail level, is all about marketing. For every straight arrow like John Bogle, there are five guys who really don’t care what you buy, just that you buy what they’re selling.

-Gray Emerson Cardiff

When the market heads south, the natural tendency is to panic or to overanalyze. The remedy is to remember who you are as an investor. As a friend put it: “It’s more about your guts than your brain.” No where is this truer than for value investing, which demands you look beyond current market passions in order to avoid what is overpriced and to grab what is cheap—even when there is no visible catalyst to create a lightning reversal of fortune. In the middle of a market downturn, value investors ought to be busy considering what Mr. Market is putting on sale rather than fixating on why we own stocks in the first place. We could spend these two pages prognosticating on the immediate future’s twists and turns, about which we haven’t a clue. We’ll leave that to CNBC’s unending cavalcade of corporate honchos, hedge fund jockeys and institutional investors, the zero sum of whose opinions reflects the entire spectrum of possible outcomes. Instead, this issue will highlight what in our own portfolio we think right now is particularly attractive. Before we do that, it’s useful to remind ourselves how we and those we admire approach investing.

Sound Advice orients its investing temper and portfolio with two complementary ideas: first we rely on our diffusion indexes of leading and lagging indicators to alert us to the state of the U.S. economy. When the economy has contracted sufficiently, as it last did in the spring of 2009, we consider it a promising time to invest. When the economy has expanded sufficiently, we consider it an early warning that times are too good to provide room for stock prices to grow. Put simply, when the business cycle is weak, we want to be buyers, and when it’s strong, we more often become sellers. The most recent data from the Conference Board (see page 10) has all of our leading indicators stronger than they were last spring, but none of the lagging indicators, which suggests that we are not near persistent market change. We expect the economy has more room to grow.

The second idea determines what we buy: we are always looking for what is cheap in terms of a company’s historical valuations, which means that what we buy invariably has significant problems that have alienated investors. You could say that these two ideas are different facets of the same



approach: we want to buy when others are selling.

Over the last couple of months, as share prices have slid beyond 10%, a common measure of what constitutes a correction, domestic reports anchored on unemployment (improving but fitfully), consumer confidence and spending (improving), interest rates (improving) and the housing/mortgage situation (mixed) should be creating optimism. Lately, it's not been domestic progress but international challenges that have generated anxiety. We needn't spend time on whether the PIIGS (Portugal, Italy, Ireland, Greece, Spain) or weaker eastern European economies will destroy the European Union's economic cooperation and throw the continent into a second financial crisis and recession, nor on what China is or is not doing to control growth to counter inflation. We don't deny these factors impact how Wall Street thinks day to day, but we're more focused on our own economy and the longer-term opportunities it offers. Like the master investors who run companies and funds in which we invest, we try to buy rather than hide when circumstances create opportunities.

On page 3, we discuss what is happening at [Leucadia](#), which issued its annual report and letter to shareholders for 2009 on April 10th. Cumming and Steinberg, who run the holding company, are not big on grand theories, so you need to look at their holdings and how they came to own them, to appreciate what makes them buy and sell. For instance, when explaining how in 2006 they came to own Keen Energy Services, which runs land-based drilling rigs that operate in the Midcontinent region, they recall that after the original owners "on a hunch that gas prices would be rising" had contracted to buy 18 new high-powered rigs...[but] realized they needed funding and turned to LUK, which became a minority owner. Then, last year after the firm continued to expand despite weak gas prices, and in November Leucadia bought what it did not already own. Buy an asset in a contracting market, and wait. Cumming and Steinberg note: "We have lived long enough to know that the natural gas market will eventually turn. At that point, Keen will rise again and generate significant cash flow, but for now we hunker down. Recessions are not kind to Keen." We expect that LUK, when boom times return for natural gas, will find a well-heeled buyer.

We don't want to give the impression that Leucadia, or we, casually can pick up distressed assets and serenely

wait for a payoff. It never happens without anxiety. As management observed after the highly lucrative sale of the WiITel, a fiber optic company bought out of bankruptcy. "Our trip through Broadband Land was at times frightening and at times exhilarating."

In discussing Leucadia's grab bag real estate portfolio, they remark: "We sleep well at night because we pay cash, expect high returns and can afford the required patience. In the darkness of the current recession, we have put nearly everything on ice and await the inevitable, if not predictable, return of the sun." To sum up: buy from distressed sellers, don't make yourself vulnerable by over reliance on leverage, preferably use your own shares to finance acquisitions and be willing to just sit there until markets move in your favor.

Dodge & Cox Stock Fund devoted its last letter, written at the end of March, to sectors that Congress and the White House are in the process of reforming: healthcare and finance, which respectively account for 20.6% and 14.8% of its assets. Because the economic consequences of reform are not yet apparent even for healthcare, for which legislation has become law, short-term concerns discourage investors from owning shares. Indeed, the fund managers acknowledge that the new law will reduce earnings in the next few years. However, Dodge & Cox has always been a long-term investor with an anticipated holding period of three to five years (and longer), and seeks "to invest when our outlook for potential earnings and business franchise value are not reflected in the current valuation." The managers explain their overweighting of healthcare shares with arguments *Sound Advice* also has employed: selling drugs, medical devices and services to the larger client base an expanded healthcare coverage provides will offset lower margins. Competitive pressures will induce companies to cut costs, expand products and penetrate new foreign markets. Of the three primary healthcare sectors (pharmaceuticals, devices and managed care), Dodge & Cox evidently sees pharma and devices as the most promising, since these are overweighted, and managed care as the trickiest, since it is underweighted.

As with Steinberg and Cumming at Leucadia, Dodge & Cox has been through enough business cycles to wait stoically for the turn that will change circumstances and investor perceptions. As with them, so too with us. SA

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Taking What the Market is Selling

Sound Advice can credit its market-beating results not just to its buy/sell signals, nor simply to its specific selections but also to its willingness to expand existing positions when opportunities present themselves either because the overall market is in decline or company-specific events have hammered a particular company. Admittedly what is cheap can get cheaper, much cheaper, but with a strong balance sheet, good management and patience such investments have been very lucrative. With the market in the midst of a 12% drop, we want this month to focus on positions in our existing portfolio that have dropped, some even more than the market, but which we know well and consider very promising: **Leucadia**, **Johnson & Johnson**, **Tetra Tech** and **Maxim Integrated**, each of which to prosper requires an expanding economy, that has come into question lately. **Transocean** is in a class by itself, however.

Leucadia (LUK—NYSE) essentially is two very shrewd businessmen, Ian Cumming and Joseph Steinberg, who understand how to make money from assets whose value others don't see or understand. So good are they at extracting milk from stones that Warren Buffett likes to partner with them when Berkshire Hathaway needs smarts to take advantage of lucrative situations. We discuss their latest letter to shareholders on page one.

Leucadia holds an eclectic accumulation of businesses, some of which LUK operates and others in which it is a passive investor. Historically, Leucadia's best known investments have been in finance and telecommunication, beaten-down companies, some acquired out of bankruptcy, which they turned around and stoically waited for a buyer to take them off their hands at a premium.

Lately, Wall Street sees Leucadia as a natural resources company, which might not jibe with LUK's past but is justified, since Cumming and Steinberg over the last few years have made significant investments in mining and other natural resource-related assets. During the latest market downdraft as investors grew concerned that global economic recovery would be tepid or even non-existent (deflation anyone?), everything from oil to iron dropped faster and further than the rest of the market. Since we continue to believe that the economic recovery will continue,

although perhaps in fits and starts, "stuff stocks" have a bright future not only because their products are essential for global economic growth but also because as hard assets, they are likely to retain value should the dollar again falter and/or inflation return. Since they peaked in mid-April at \$28.05, shares in Leucadia are now at \$20.41, a 27% drop but still nearly twice the price they fell to at the March 2009 bottom.

The biggest single current investment on Leucadia's balance sheet is in Fortescue Metals Group (\$1.21 billion), an Australian iron ore miner whose infrastructure Leucadia in 2006 helped build to get its ore not only out of the ground but onto boats by constructing a railroad and port facility. Cumming and Steinberg are deservedly known for capitalizing on underappreciated assets, so it might come as a surprise that they are also willing to invest on speculative high risk/high reward situations. For example, Leucadia has two natural gas projects, both of which are outside the norm: a planned onshore liquefied natural gas terminal on the Oregon coast, and four gasification projects in the Midwest and Southeast that if successful would convert coal or petroleum coke into "substitute natural gas," methanol and other gasses. Neither becomes profitable unless natural gas prices rise significantly from their currently depressed levels. Each plant either has or is requesting subsidies from the Department of Energy and/or state authorities.

As the current and past deals with Berkshire Hathaway demonstrate, Leucadia has an extraordinary history of capitalizing on distressed financial assets, which explains why starting in the 2008 financial collapse it spent \$418.6 million for a 25% interest in AmeriCredit Corp (ACF—NYSE), an auto-lender in the subprime market, worth currently \$710 million. Leucadia also has capitalized on its own share price. For example, when during the first quarter of 2008 LUK shares had raced above \$50, it swapped 10 million of them to Jefferies (JEF—NYSE), a full-service global investment bank and institutional securities firm, for 25.6 million Jefferies shares plus \$100 million in cash. The position in Jefferies now is worth \$1.16 billion, while those 10 million LUK shares have dropped to just north of \$200 million. That Jefferies is unknown to most investors is a good thing, evidence that it never got caught up in the 2007-2008 financial fiasco. JEF lately is worth 44% more than the purchase price.

These are the primary building blocks for Leucadia. Naturally LUK's prospects for returning to where it traded in early 2008 or even last April, depends as does most of our own portfolio, on a recovering economy. See the cover essay for more about how Leucadia thinks. Historical comparisons show currently LUK's Price to Earnings ratio is less than a quarter of where it's been over the last decade, Price to Sales is at two-thirds and Price to Book is three-quarters, all of which either are or are close to their lows of the past decade. We recommend buying LUK up to \$27.

Tetra Tech (TTEK—Nasdaq) combines several businesses that build on its engineering prowess and expertise in environmental remediation, especially when it comes to water. We think that demand for such expertise can only burgeon not just in the U.S., where TTEK does the bulk of its business, but especially internationally.

The problem for Tetra Tech—and the opportunity—is that the global recession that exploded in 2008 and only now is dissipating has reduced revenues throughout its sector. Consider that at least 68% of TTEK's sales come from government and quasi-government funding, which has slacked off. In its 2010 Q2 report, management notes that revenues from federal projects, its largest contributor, had declined 7.9%, though revenues from states and smaller jurisdictions increased 15.8%. Beyond government contracts it was even worse: commercial sales, primarily for real estate development projects, dropped the most, down 35%. At the end of 2009, backlogged projects were down 4% to \$1.6 billion, influenced by completion of an Iraq project and cancellations by state, local and commercial clients.

In tough economic times, however, competitors are faring even worse, and for Tetra Tech, which has a long history of bolting on small acquisitions either to deepen existing strengths or to expand into new areas, industry weakness has meant deals to be made. TTEK during the energy crunch, for instance, surged after it acquired in 2007 companies with wind-power technology. Many investors then reframed the firm not as a stodgy engineering company but as an alternative energy pioneer, which exaggerates the contribution wind at least for now makes to total revenues. In early 2009 Tetra Tech bought a small (\$14 million in annual revenue) nuclear science and engineering firm that worked with the DOE at the Oak Ridge complex and other locations, and this year added another nuclear

energy acquisition. For the first time since Three Mile Island put a curse on nuclear power, the U.S. is seriously planning to revive such developments. We like Tetra Tech preparing for that eventuality.

Tetra Tech also wants to expand its geographic reach. Though it has done environmental work for the U.S. government in Iraq and elsewhere, the potential for doing business with foreign customers is compelling. Last year, TTEK bought Wardrop Engineering, a Canadian firm with offices in the UK and India, whose environmental business mirrors Tetra Tech's, for less than \$100 million. Thanks to Wardrop's addition, international revenues jumped 49.7%, albeit from a modest base, for the first half of the current fiscal year.

TTEK shares peaked last August, and since then are down about 33% after it began reporting diminished revenues that continue this year. Tetra Tech is among the best positioned engineering firms and will prosper once funding returns either because economies have emerged from recession and/or the urgency of environmental projects precludes delay.

At current prices, TTEK's price ratios are substantially below their average levels for the last decade. Indeed, they have never been cheaper. We suggest buying TTEK up to \$26.

Maxim Integrated (MXIM—Nasdaq) designs and manufactures analog and mixed (analog/digital) semiconductor chips used in everything from mass-market products like cell phones to high performance chips in industrial niche products such as monitors and gauges. Historically, MXIM's core business had been these high-performance, highly engineered chips that enjoyed high margins and long product cycles, but earlier in this decade management decided to expand its consumer-oriented business, which meant an increase in revenues but a decline, at least for those products, in margins. Mass-market products, though they generate high revenues albeit at lower margins also tend to have much shorter product lives as Maxim's customers need to tantalize consumers with new products with different chip specifications.

As with all semiconductor manufacturers, the crucial question is how strong and how long the recovery from recession will be? Compared to where revenues were last year as global economies tried to stabilize, MXIM has done an excellent job. Revenues over the last nine months are up 14.4% and gross margins have increased even faster. Operating income has risen to

\$151 million. At the same point last year MXIM saw a \$4.2 million loss. Proportionately operational costs fell. This fiscal year, however, earnings exploded for the first three quarters from a depressed penny to 22 cents.

Though fundamentals have improved, it's not carried over to the share price. Both Maxim and its peer mixed signal competitor, Analog Devices, are underperforming the broader semiconductor industry, which makes both very attractive on the basis of valuations.

Looking forward, we note that bookings for new orders rose 43% faster than at the same point last year, which accounts for a backlog of unfilled orders that is 44% above 2009's measure. In fact, Maxim's numbers would look even better were production and sales not constrained at the moment by shortages of some supplies. The downside of being unable to meet demand is that customers might look elsewhere, especially for the more mass-market chips Maxim lately has begun to supply.

Maxim's balance sheet, which is what first attracted us to the company, remains robust with almost \$900 million in cash and zero long-term debt, which allows the company to repurchase shares (since October 2008, \$348 million in shares at an average price of \$14.38) and pay an above-average yield (4.6%), especially for a tech company with substantial prospects for share appreciation. It also continues to make relatively small acquisitions to expand existing businesses or to edge into proximate ones.

After a strong performance during the 2009 recovery (+85%), this year has been a challenge with the shares down 15%, considerably worse than the tech-centric Nasdaq (-2.2%) as well as against the HOLDRS Semiconductor ETF (-2.5%). Over the last decade, Maxim Integrated has traded at 2.4 times the current Price/Book ratio, 2.9 times the current Price/Sales ratio and 1.7 times the current Price/Cash Flow ratio. Only the Price/Earnings ratio, skewed by extraordinary write-offs over the last 12 months, diverges from this pattern. Compared to the past decade, the P/E ratio is 1.7 times the historical average. With the exception of 2008's devastatingly bad results, the trailing 12 month's ratios are lower than they have been over the previous decade. We're counting on a continued economic recovery that allows Maxim to play catch up to its benchmarks and recommend MXIM up to \$21.

Johnson & Johnson (JNJ—NYSE), if you count its many businesses, looks more like a medical mutual fund than a single corporation. JNJ has deep and broad exposure to almost every subsector: pharmaceuticals, medical devices and non-prescription drugs. It's a juggernaut, but lately JNJ has been the object of FDA scrutiny after the recall of more than 40 of its products marketed for children including liquid Tylenol and Benadryl from its McNeil Consumer Healthcare division. Costs related to recalling almost 200,000 units, potential fines and regulatory controls that might be imposed add to the expenses of closing the plant from which these products came. The plant will reopen after JNJ has satisfied the FDA. The damage, we believe, is reputational and won't have a long-term impact on JNJ, but does create a drag on (and an opportunity for us) JNJ's share price.

JNJ in addition to being highly diversified is also a financial fortress with a market cap of \$165 billion, throws off \$5 billion in free cash flow and has \$18 billion in cash and liquid investments sitting on its balance sheet. With its now rare AAA credit rating, JNJ can absorb any potential costs of remedying the McNeil problem's legal and regulatory challenges without breaking a sweat. What makes the McNeil issue ironic is that JNJ's handling of the famous Tylenol tampering incident back in 1982 provided a huge boost to the company's stature and has become the textbook example of how to deal with what could have been a PR catastrophe.

Like most other mega-cap blue chip stocks, which relatively speaking did not dive too deep during the 2007-2008 bear market (JNJ lost 33% less than either XLV, a healthcare ETF or the S&P 500), Johnson & Johnson also did not rebound as vigorously since the March 2009 bottom. The standard arguments by JNJ's critics start with expiration of patent protection for prescription drugs such as Risperdal (anti-depressant) and Topomax (epilepsy) and the emergence of generic versions, the diminished popularity of JNJ's Cordis division's stents for vascular blockages when compared to stents sold by Abbott and Boston Scientific, so-so performance for some of JNJ's more recently launched drugs, a stronger U.S. dollar that erodes the value of foreign revenues and, above all, anxiety that healthcare reform will erode margins and profits.

These concerns are real but are a perennial part of the healthcare industry. New JNJ drugs such

as Stelara, a treatment for psoriasis, are coming to market, and stalwarts like Remicade, used for inflammatory diseases and Procrit, used to treat anemia, are anchors for continuing profits. JNJ also partners with smaller firms to develop and/or market innovative drugs such as Telaprevir, which Vertex Pharmaceuticals pioneered to treat Hepatitis C and is now in late-stage testing. The pipeline is also reasonably stocked, though you can presume some drugs will fail to reach FDA approval.

Also, JNJ with its huge cash horde does make judicious acquisitions to deepen or expand its product lines such as its 18% buy into Elan, which opens Elan's anti-Alzheimer disease research now and sets up a possible acquisition later.

Finally, take a look at the cover essay remarks from Dodge & Cox about how reform both hits and supports drug and medical device companies.

If we look at historical valuations, Johnson & Johnson, though traditionally it has traded at a premium to the S&P 500, is as cheap as it's been over the last decade. The Price to Earnings ratio, which over that period has averaged 21.3 (versus the S&P's 18.4) now stands at 12.6 (versus the S&P's 15.5). The Price to Sales ratio currently runs at 2.7 versus 3.9 over the last decade. The Price to Book ratio runs 3.1 compared to its decade average of 5.2. Finally, with the price low and management recently increasing the dividend, the yield runs at 3.7%, attractive in an interest rate environment that pays 3.3% on a 10-Year Treasury Note. Buy JNJ up to \$68.

The final recommendation comes with a special *caveat emptor*. Shares of **Transocean (RIG—NYSE)**, despite our repeated view that it was wrongly being vilified with BP, have suffered the worst damage among all the prime players in the Deepwater Horizon catastrophe. Whereas universally criticized and apparently entirely responsible (legally, financially and operationally) BP has seen its shares fall by 38.6% since April 20th, Transocean shares have dropped 45.5%. Some of this damage has nothing to do with the spill itself in the Gulf of Mexico. Even were the Deepwater Horizon still in operation, energy and energy services shares would have fallen during the market reversal that began on the Monday after the drilling platform exploded.

Sound Advice can credit its market-beating results not just to its buy/sell signals, nor simply to its specific selections but also to its willingness to expand existing positions when opportunities present themselves either because the overall market is in decline or company-specific events have hammered a particular company.

As we have noted, BP, according to RIG's SEC filings will "assume full responsibility for and defend, release and indemnify us from any loss, expense, claim, fine, penalty or liability for pollution or contamination, including control and removal thereof, arising out of or connected with operations under the contract" There might be other costs that Transocean faces, but it has nearly \$1 billion in primary insurance and several complementary policies. The \$13.4 billion of RIG's vaporized market cap grossly exaggerates RIG's liability.

There's no reason to waste space repeating why deepwater drilling will remain a crucial, perhaps the crucial, part of providing new oil and gas to the world. Obviously the six-month moratorium Washington has placed on new drilling in the Gulf and elsewhere as well as cancellation of lease sales in other areas force us to ask whether we could see complete curtailment or severe limitation on marine drilling that would decimate Transocean's revenues. Such a radical limit is remote, perhaps impossible. Aside from the bald truth that the global economy depends on such submarine fields, we would expect, were such an outcome being taken seriously, even by those shorting Transocean, the price of oil now would be over \$100 and climbing. It isn't.

Comparison of RIG's historical valuations at this juncture is almost pointless, since the abrupt drop in RIG's price has distorted the ratio of price to earnings, book, cash flow and sales. These numbers, because they are based on pre-Deepwater Horizon results, will come down over the short-term as revenue is reduced by the moratorium.

But consider this: in its most recent 10Q, Transocean reports that the insured value of its fleet, which approximates its replacement cost, is approximately \$39 billion. On the eve of the Deepwater Horizon explosion RIG's market cap was \$29.5 billion, a 24% discount from the insured value of its rigs. At today's close, the market cap for the company stands at \$16.1 billion, that is, the shares are trading at 59% discount to the market value of its rigs. If, as we think, the market is wrong about RIG, this could be a once-in-a-lifetime opportunity. But you'll need nerve to do it. We recommend buying RIG up to \$65. SA

Portfolio Updates

Though we've never given much credence to the "Go Away in May" school of investing, like the guy who doesn't mind walking across a black cat's path and then gets hit by a car, we have to wonder whether avoiding May, regardless of why, might have some validity. It was a bad month.

Since we priced the last issue on May 7th, the Dow has lost 4.3%, the S&P 4.1%, the Nasdaq 2.1% and the Wilshire 5000 3.8%. The *Sound Advice* portfolio dropped 4.2%, hurt most by our half dozen energy and natural resource stocks, which fell 7.8%. The best performance came from our most defensive sector, healthcare, whose six positions on average advanced 3.4%. But both numbers are skewed by a single position: **Transocean**, the ultra-deepwater driller, which owned the Deepwater Horizon that BP leased in the Gulf of Mexico, collapsed 26.2%. **Odyssey Healthcare**, the hospice service provider, which Gentiva has agreed to buy for \$27 a share, leaped 39.8%.

We have decided that it's time to sell ODSY.

The outsized drop in natural resource stocks is hardly a mystery. Financial problems in Europe that first erupted in Greece and, just as we closed this issue, touched Hungary have undermined confidence that Europe can emerge from its own recession, which means slower global economic growth. A stagnant Europe impacts demand for commodities but also has caused a rapid retreat for European currencies, but especially the Euro. Though the U.S. itself is not clear of the same recession, the fall of the Euro automatically translates into a more expensive U.S. dollar. Metals, energy and other commodities, because they are priced in U.S. dollars, fall in price. If the pricing mechanism isn't clear intuitively, think of oil, for example, as just another currency, which adjusts lower in price as the dollar increases. Though headlines concentrate on instability in Europe, trends in China are also unnerving investors. Beijing is sending out very divergent signals. On the one hand credit is being restricted to tamp down speculation, especially in real estate, and to avoid inflation. This eventually cools demand for copper, iron, coal, lumber and all the other materials necessary in construction but more immediately causes investors to ratchet down expectations for those who produce these commodities. But on the other, China needs to avoid a global economic slowdown that would reduce demand for its products, so it signals it intends to keep its economy expanding. Finally, here at home, Friday's extraordinarily disappointing employment figures pole-axed a market that had anticipated a robust report and renewed worries that the U.S. could slip back into its own recession.

Fundamentals are nearly irrelevant when pessimism reigns, but ultimately they prevail. We continue to bet against pessimism and are positioning the portfolio in anticipation of a substantial, if not consistent, recovery in the U.S. and globally. Accordingly, we like natural resources investments. See our comments on **Leucadia**, **Tetra Tech** and **Transocean** on pages 3-6.

Optimism does not preclude pain. Concerns about a slowing economy and a stronger dollar hurt **Leucadia** (-10.7%), **Plum Creek Timber** (-7.7%) and **Agrium**, the fertilizer manufacturer (-10%). **Anglo American** dropped 3.5%. Oil had fallen below \$70 as part of the global slowdown story, but rallied somewhat. The **Fidelity Select Natural Gas Fund** is 4.1% lower. **PowerShares Water Resources ETF** lost 4.8% and **Tetra Tech** 5.6%. Companies with mining operations in Australia (**Anglo American** gets about 10% of its revenues from there) are concerned about a proposed special tax on their revenues from the current 43% to 58%. The proposed tax also would impact **Leucadia**, which has a large investment in **Fortescue Metals**, an Australian iron ore miner.

Given the pressure on commodity-based economies such as New Zealand's, and concerns over global economic slowing that has been hard on telecom access providers, more trouble at **Telecom New Zealand** could be expected. On no company specific news, NZT is off 13.4%.

USAA Precious Metals & Minerals Fund, dropped 0.7%, the result of cross currents: a stronger dollar impacts precious metals in the same way that it does oil, but a weaker Euro has stampeded European cash into the same metals, thus providing support. Add in global anxiety about economic and geopolitical stability (Korea and the Mideast are in the news) and you can appreciate why **USAGX** has held even.

That same flight to safety gold evidences also drove money into U.S. Treasuries, forcing prices higher and yields lower. We confess that our estimates of where U.S. interest rates would head did not take into account a Euro panic. However, we stress that anxiety over Europe ultimately can't check rising interest rates once investors recognize the problem profligate credit creation both there and here has set in motion. But that is the future. At one point in the Euro panic, it looked like the 10-Year Treasury Note was headed for 3%. It's now at 3.2% after hitting 4% in April. **ProShares Ultrashort 20+ Treasury ETF** since the last letter lost 6.3%.



This table is updated with live prices, charts & buy limits on our website:

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

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
HRPT Properties	HRP	NYSE	\$6.35	7.56%	\$7.00	BUY
Telecom New Zealand	NZT	NYSE	\$6.23	11.40%	\$7.25	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$51.62	0.21%	\$65.00	BUY
CarMax	KMX	NYSE	\$20.93	0.00%	\$26.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$21.11	2.93%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$28.28	1.54%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$91.69	1.19%	N/A	BUY
Fastenal	FAST	NASDAQ	\$49.41	1.42%	\$55.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$17.55	1.88%	N/A	BUY
Honeywell	HON	NYSE	\$41.07	2.95%	\$49.00	BUY
International Speedway Corp.	ISTA	NASDAQ	\$26.87	0.60%	\$31.00	BUY
Johnson & Johnson	JNJ	NYSE	\$58.01	3.38%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$20.42	0.00%	\$27.00	BUY
Mattel	MAT	NASDAQ	\$20.85	3.60%	\$26.50	BUY
Microsoft	MSFT	NASDAQ	\$25.79	2.02%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$41.64	2.31%	\$52.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$26.54	0.00%	N/A	SELL
Stryker Corp.	SYK	NYSE	\$51.97	1.15%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$14.31	4.47%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$21.20	0.00%	\$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$41.83	2.73%	N/A	BUY
United Parcel	UPS	NYSE	\$60.56	2.97%	\$70.00	BUY
UnitedHealth Group	UNH	NYSE	\$30.34	1.71%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$50.40	2.40%	\$60.00	BUY
Xerox	XRX	NYSE	\$8.88	1.94%	\$11.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$17.86	0.00%	\$22.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.22%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$33.91	4.95%	\$40.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$15.64	0.51%	\$19.00	BUY
Transocean	RIG	NYSE	\$50.20	0.00%	\$65.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$36.17	0.03%	N/A	BUY
Aggressive Growth						
AOL Inc.	AOL	NYSE	\$21.28	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$5.74	0.00%	\$8.50	BUY
Comcast	CMCSA	NASDAQ	\$17.79	1.83%	\$21.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	8.61%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$44.67	7.28%***	\$50.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$9.25	6.92%	\$10.06	BUY
Liberty Global	LBTYA	NASDAQ	\$25.03	0.00%	\$32.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$17.12	4.67%	\$21.00	BUY
Symantec	SYMC	NASDAQ	\$13.92	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd***	TFCVX	800-443-1021	\$10.69	2.23%	N/A	BUY
Time Warner	TWX	NYSE	\$30.46	2.76%	\$34.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$38.73	0.00%	N/A	BUY

* Prices as of Friday, June 4, 2010

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

*** Dividend Deferred

*** Covers distributions from Aug 31, 2009 - March 31, 2010

BUY, HOLD, SELL OR LIMIT IN BOLD INDICATES A CHANGE IN ACTION OR LIMIT

UnitedHealth, which despite recently seeing its share price battered along with those of other HMOs, does not see a bleak future. Rather it's signaling by significantly increasing its dividend to 13 cents from less than a penny per quarter that it expects to prosper. UNH is up 5%.

Boston Scientific has entered investor limbo, where no buyer seems to notice its existence and sellers, whether they own shares or are just shorting a wounded company, sell on general market weakness, problems at Boston competitors and even a whiff of disappointment from the company itself. Since the last letter, BSX slipped another 10% on nothing but investor apathy. We're resigned to waiting for Boston Scientific to have a positive quarter that will surprise Wall Street before we can expect the share price to start a recovery. There are sufficient reasons to expect BSX to pull itself together. New products continue to be launched and others are in the development pipeline. In addition, Boston Scientific invests in junior companies with promising technologies. For example, the media recently reported that Cameron Health has demonstrated a new defibrillator wiring set that is placed not in the heart but adjacent to it, which reduces the risk of insertion, a substantial improvement. Boston Scientific has funded Cameron Health, and has an exclusive option to acquire the smaller company. Finally, we can't imagine how Boston Scientific could have a poorer public image than it does. We think the defibrillator recall marked that ignominious bottom.

Ford continues its recovery, though the stock price has flattened out for the time being. We own not the Ford common shares but the 6.5% convertible preferred, which can be exchanged for 2.4289 shares of the common. At the current price of Ford (\$11.50), this amounts to \$27.93 worth of the common, which pays no dividend. What makes the preferred the preferred way to own Ford is that for the additional \$16.74 that you pay for the preferred, you are entitled to receive a \$3.25 annual dividend. If you think of the preferred as two separate investments, one, the \$27.93 in Ford common the preferred represents and another an interest paying security that yields 19.4% (3.25/(44.67-27.93)), it is seductive. However, there is a problem with this wonderful situation: as part of the drastic efforts to shore up the balance sheet during the darkest days for Ford back in January 2009, Ford deferred payment of the dividend. Shareholders naturally are anxious that Ford resume payment. When that occurs, they will receive not only the deferred payments (which now amount to \$4.06) but also interest on that amount. But don't expect the event soon. Ford is in no rush to weaken its balance sheet when it still needs all the cash it can muster. The preferred slipped 1.9%.

Technology stocks fell with the rest of the market.

Symantec, which announced it was acquiring VeriSign's

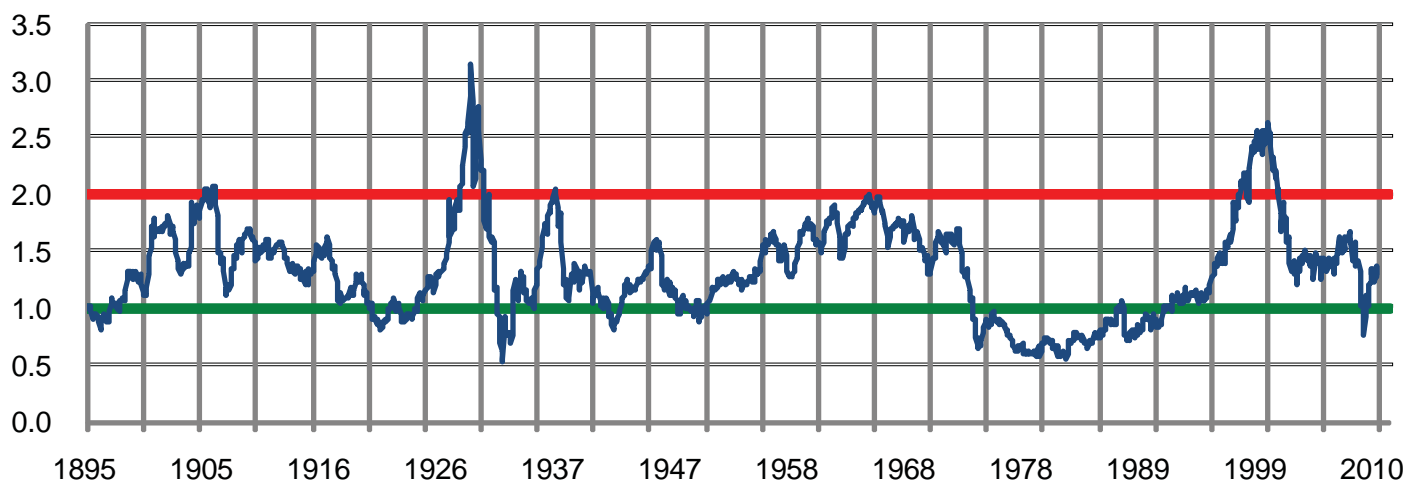
authentication services for \$1.28 billion, a move intended to buttress its corporate business and marks another step toward SYMC diversifying away from what had been its sole focus on consumer and small business PC security software. Nonetheless, making an acquisition this large in a shaky market is not a confidence builder, especially or Symantec, which still is trying to convince investors that its admittedly pricy acquisition of Veritas several years ago ultimately does make sense. Veritas specializes in managing large scale data banks, which continue to explode in size to meet demand from business and consumers. As Symantec weaves Veritas' expertise into the fabric of its security expertise, the combination offers customers a powerful package.

We bought in after the acquisition's initial damage had occurred, and Veritas has opened up new revenue. SYMC is off 10.9% since the last letter.

Microsoft, despite strong sales for its new Windows operating system and expectations that corporate buyers are primed to replace the previous generation of desk and laptops, got pummeled as well, dropping 8.1%. The challenge for MSFT is to remain relevant when smaller, mobile devices like tablets and cell phones gain in popularity. Microsoft can retain its corporate dominance, but must address this changing broadband landscape. We think it can.

REITs retreated along with most financial services sectors as investors fretted over what a slowdown would do to rents and property values. **HRPT Properties Trust** dropped 8.2% since the last letter, and **CGM Realty Fund** 5.6%. One aspect of the Heebner fund to keep our eye on is the reemergence of mining stocks in the portfolio, which Heebner rationalizes as appropriate because mines are real property and their output is an essential part of new construction. Regardless of whether you buy Heebner's rationale, it was mining stocks that provided CGMRX with such explosive performance in 2006 and 2007 when they nearly dominated its holdings. In the most recent SEC filing, Heebner reports that REITs accounted for 61.2% of the portfolio, down from the previous quarter's 66.5% while metals and mining shares increased from 17% to 26.5%. Heebner never has been half-hearted when he makes a move, and he clearly is signaling an expectation that demand for metals in an improving economy can power his fund's performance.

The recent market has been sobering. In some cases, such as Transocean, panic has set in. If you are certain that the economy here and abroad is in the first stage of a renewed recession, then getting out is prudent. Instead, as we say on the cover essay, from our perspective this is a correction early in an extended market rise. We're not preaching bravado in the face of chaos. We believe it's a time for judicious buying, not selling. SA



The Risk Indicator measures the overall risk in the stock market by plotting the ratio of stock prices to home prices. See *The Science of Making Money in Turbulent Stock Markets* for a full explanation of the Risk Indicator and the Diffusion Indexes. Median home prices have been flat for the last ten months, so the risk indicator is primarily a reflection of stock prices. The latest reading is 1.21. This reading reveals that stocks are still below their average relative to house prices, and present a better value. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

The SoundAdvice Diffusion Indexes

The Diffusion Index of Leading Indicators gives “Aggressive” signals when all four of its individual leading economic indicators drop below their respective levels

Track Record of the 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 produces an annual return of 19 percent. During “Caution” signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators would hit zero in March, 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.

An “Aggressive” signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. See *The Science of Making Money in Turbulent Markets* (which you received with your subscription) for a history of Supercycles. You will also receive an updated copy when you renew your subscription.

The 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. This reveals a strengthening economy and inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 0 percent, which means that all of the individual lagging indicators are below their levels of six months earlier.



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