



Wall Street took a deep sigh of relief Monday after European governments mounted a trillion dollar defense of the sovereign debt of Greece and of other shaky Eurozone states but also the Euro itself. What the governments' statement did not say, but everyone should understand, is that the biggest unnamed beneficiary of that trillion dollars would be international banks, especially European banks which own much of that debt. Over night, those banks went from flirting with insolvency to happy days.

The same could be said about the real purpose in 2008 of the AIG bailout and much of the TARP dispersals. Yes, they stabilized the credit markets but they also saved investment banks like Goldman Sachs from massive losses had they had to negotiate pennies on the dollar rather than getting 100 cents. And the Fed keeps on giving to keep the banks prosperous: the current Fed Funds Rate at effectively zero lets banks borrow from the Federal Reserve, then use that free money to buy Treasury notes and pocket the spread. For instance, the 10-Year yields 3.5%--pure profit on a risk-free "investment." Too bad the rest of us can't play that game.

But there's nothing new in that. We don't have the same privileges, which gets overlooked in good times. When the market falters, however, the tension between the insiders and the rest of us chafes. The last time public disdain for finance was this deep was the Great Depression.

We've puzzled in print about why retail investors were not buying into the super rally that began last year, and had attributed it to skepticism about the market's ability to keep pushing higher. I'm beginning to think it's a mix of distrust and disgust. That's regrettable. Small investors can make serious profits. We've demonstrated it's possible. But you can't do that from a money market fund or a certificate of deposit.

**-Gray Emerson Cardiff**

## Back to Even

We closed the May issue last Friday after a difficult week that climaxed with Thursday's intraday 1000 point Dow drop. Friday's roller-coaster ride finished with the standard averages down anywhere from 1.3% (Dow) to 2.3% (Nasdaq). Two weeks before, on April 23rd, stock prices had been at a post-March 2009 high. Since then the averages are down 9%. Earnings season was in gear and those numbers on the whole looked good. Economic indicators continued to show recovery, and though the credit crisis in Greece flared intermittently, a resolution seemed to be forming.

When we priced the May portfolio, it and our benchmarks were back to where stock prices stood as 2010 began, though we shouldn't forget that those same benchmarks are on average 67.5% above where they bottomed 14 months ago. Back then, *Sound Advice* was among the very few to turn bullish. To most investors, both professionals and individuals, it was obvious that stock prices were headed lower still. Instead, share prices exploded.

Investors now seem just as shocked that this prosperous market has folded so abruptly. The question, of course, is what we should be doing now? As veteran *Sound Advice* readers know, when prices fall, we like to buy, especially when, as now, our indicators say buy. Shelby Davis, a legendary investor observed: "You make most of your profits in a bear market. You just don't realize it at the time." We're not now in a bear market, but the principal is always true: buy when others are selling, a distinctly uncomfortable way to act.

We humans are risk adverse, which puts us at a disadvantage in markets, since they reward risk taking. Consider mutual fund investors, for example, whose returns paradoxically usually lag the performance of the very funds they own. *Morningstar* has published numerous studies, which demonstrate that investors tend to sell down their positions when prices are falling and fatten them up as prices rise,

The **SoundAdvice** portfolio is up **30.81%** since 1/1/2009

**SoundAdvice** vs the S&P 500

Since 1/1/2000, \$25,000 becomes:

**\$71,149**  
with **SoundAdvice**

**\$22,799**  
with the S&P 500



which turns the first (and only) law of thermo investing upside down: they sell low and buy high.

Did you bail out in 2003, or 2009? Did you get in too deep in 1999 or 2007? If you are comfortable with only consistency, we recommend you avoid exposure to market volatility, which means you ought to avoid equity investing. One key to *Sound Advice's* success is that we remained fully invested, altering our portfolio to take advantage of what the market put on sale. We also pay attention to our Diffusion Indexes (see Page 10), which tell us when to be cautious in our choices and when to be aggressive. On the following pages the funds we own all have low turnover ratios and take a long-term approach. Our advice to you now is to remain committed to the market, and when prices get pummeled to take advantage.

Easy to say but hard to do especially when Wall Street reminds us that individual investors too often are just dupes. The 1000-point plunge and then the 650 point bounce on May 6th showed us not just that computerized high-frequency trading can create disasters but that even when they are working as intended can disadvantage the rest of us. Indeed, we still don't know what happened. Initially rumors flew that a mistaken trade on futures contracts on the S&P 500 tripped hair-trigger computer programs to flood the market with sell orders. Rather than an erroneous trade that set off a blizzard of computerized sell orders, it is more likely that the chaos resulted from high-frequency traders who once a decline was evident, suppressed any buy orders, which left a huge vacuum into which unbraked share prices hurtled lower.

These same high frequency traders, when critics in calmer times said these nano-second transactions not only were unfair but could destabilize markets, argued that their trades provided liquidity that could stabilize not destabilize markets. If they did step back as the market collapsed (which they had every right to do), their passivity was crucial to Thursday's unruly implosion. Once again, we saw how Wall Street serves itself. How many investors or potential investors watched the mindless volatility and decided this Wall Street stuff was not for them?

During the recent Senate grilling of Goldman Sachs' senior executives and traders, no one on Goldman's side of the table grasped that the public assumed they should act in the interest of their customers. Instead, the Goldman guys defended their actions by distinguishing between acting as brokers, when they acted for their own portfolio or simply facilitated a transaction for a fee, in which case they had no responsibility to be transparent and when they acted as advisors and did need to put their clients' interests ahead of their own. Still, no one at Goldman could restate with a straight face Charlie Wilson's 1955 congressional testimony to the effect that what's good for General Motors is good for America. What's good for Goldman is, well, good for Goldman.

It seems we learned nothing from this decade's previous two great financial scandals tied to Enron and then to Henry Blodgett. Enron was a house of financial engineering built on bogus profits that morphed into fraud, while Blodgett was merely the most prominent example of how Wall Street firms churned out "research" designed not to assist their investing clients but to ingratiate themselves with corporations, even those that were deemed "crap," in order to win those firms' underwriting and banking fees. None of this came as a surprise to Wall Streeters. It was an open secret. Indeed, we have to wonder now whether the same wink-and-nod attitude surrounded those AAA ratings from Moody's, S&P and Fitch's that seduced institutional buyers into trusting CDOs blessed with them or the accounting rules that fostered them.

And then there is the media, which even if its practitioners aren't out to deceive you as was Blodgett, are so short-term oriented that they must reinforce whatever the crisis or delight of the day might be. In bull markets they are bulls and in bear markets they are bears. In between, to hold your attention, they just generate anxiety.

As investors, ignore the wisdom of the herd, buy what is sold and be patient. We're back to where we began 2010. We have opportunities provided we don't get caught up in the day-to-day market movements, and instead focus on value and long-term goals. SA

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# Mutual Funds

Funds, especially general funds, though they account for nearly a quarter of the *Sound Advice* portfolio, can get neglected. At least with sector funds such as **Fidelity Select Natural Gas**, we can put performance within a clearly defined industry and discuss its dynamics. Even with general funds it's important to keep track of how funds are evolving, so at least once a year we want to take a closer look. This month we'll start with four funds, two each from Dodge & Cox and Third Avenue, all of which have a value-driven approach. We'll cover the others over the next few months.

With the exception of Ken Heebner's **CGM Realty Fund**, our funds exhibit low turnover ratios. The now fashionable view that Buy and Hold no longer is viable, which is another way of advocating trading in and out of positions, does not convince us. We believe there are valid reasons for long-haul investing either because we continue to see future profit in investments that show success, or remain confident that the pay-off for a yet unsuccessful investment is substantial enough to justify absorbing the pain. As difficult as that perspective feels after the pasting the market absorbed in early May, this is how we operate. Of course, we acknowledge that each of these reasons can cut the other way. On balance, however, we have done well, and admire patience, which brings us to **Dodge & Cox Stock Fund (DODGX)**.

The average large cap domestic equities mutual fund carries a 1.34% expense ratio, which cuts into performance. For DODGX the expense ratio is 0.5%, which is attributable to three factors: first, Dodge & Cox spends zero on advertising and self-promotion. Second, the company charges reasonable fees for extraordinary results. Finally, DODGX keeps its trading costs low by not trading much. Last year, DODGX turned its portfolio over at an 18% rate, while the average domestic stock fund (including index funds) ran a 97% ratio, that is, these funds were moving out of a typical position after barely 12 months, which blares either a lack of patience, or conviction, or both.

But at market turning points, DODGX does take advantage and overhauls its portfolio. Between 2001 and 2006 turnover averaged just under a placid 11%. In 2007 and 2008, tumultuous years, the ratio hit 27% and 31%, levels not seen since 2000 when

the ratio was 32% and not coincidentally, thanks to those decisions, prefaced three successive years of extraordinary outperformance. Last year and so far this year, DODGX is outperforming the S&P 500.

Changes at the sector level since we last looked closely at the portfolio have not been dramatic. Among the largest sectors held, healthcare, which had constituted more than a quarter of assets in mid 2009, has shrunk to 20.6% and financials, which had crushed DODGX and other value funds in 2008, has expanded to 14.8% from last June's 11.2%. However, Dodge & Cox does not structure its portfolio thematically. Instead the management team builds its portfolio one stock at a time. When you see sector concentration, it simply reflects the market's tendency to disrespect entire sectors, thus creating overlapping bargains Dodge & Cox pounces on. But selections always begin with specific companies such as Diageo, the European distiller, that entered the portfolio late last year and then increased dramatically when its shares tumbled in February after quarterly results fell short of expectations.

Let's glance at the largest DODGX sector, healthcare. In the year-end annual report to shareholders, the fund explained that investor anxiety over how healthcare reforms might impact the sector contributed to "historically low evaluations" and ignored how "well positioned [such companies are] to take advantage of the powerful trends of globalization and rapid technological change." Hence, during 2009 and early 2010 DODGX expanded its exposure with companies like Medtronic, Sanofi-Aventis and Merck.

The clearest example of expanding a position on weakness hits close to home for us. Dodge & Cox has owned **Boston Scientific** common stock and debt in several funds since 2007 after the shares imploded in the wake of the Guidant acquisition. Last year, as the shares rose, management trimmed its position slightly, but this year, as other shocks hit BSX, Dodge & Cox aggressively expanded its position. During the first quarter, the number of shares jumped by nearly half to 65.3 million. Needless to say (but we'll say it anyway), we take comfort that a fund we respect parallels our own thinking about beleaguered BSX.

The overlap between DODGX and the *Sound Advice* portfolio reflects shared instincts. In addition to BSX

there are another nine positions *Sound Advice* also holds as well as a number of other stocks we have owned in the recent past. Among all the funds we know, Dodge & Cox Stock Fund's selection process comes closest to how *Sound Advice* operates, though we've had a significantly better annualized track record (+11.2%) over the last decade. Nonetheless, as a diversified investment Dodge & Cox Stock Fund from its inception in 1965 is among an elite group of high-performers. Over the past decade, it's the ninth-best large cap value fund (+5.3%). Were we to recommend a single surrogate for our portfolio, we could do no better than this fund.

**Dodge & Cox International Stock Fund (DODFX)**, which also boasts a superior performance record over its decade-long history and modest expenses, is the **Dodge & Cox Stock Fund** in translation, at least in terms of method, research and discipline, which is the foundation for the fund family's outperformance. As the International Fund's managers observe in their year-end letter to shareholders: "Dodge & Cox has successfully navigated turbulent markets over the past 80 years, and we have learned that successful long-term investors stay the course in periods of poor market performance, setting the stage for attractive future returns. Historically, the two key elements of superior equity returns have been valuation discipline and a long term time horizon." One indicator of consistency: the international fund's turnover ratio has averaged 14.8% compared to the domestic fund's 17.6% over the same period, while the average large cap value foreign fund sports a 65% ratio.

The similarities between the domestic and international funds go deeper. Although Dodge & Cox managers work from the bottom up, that is, their portfolios are built stock by stock without concern with any overarching market theme, the two funds' sector distributions are similar. Information technology, consumer discretionary and healthcare are all given more weight both internationally and domestically. The absolute heaviest exposure for the International Fund's portfolio is in finance at 22.1%, although that still is 13% lighter than finance's weighting in DODFX's benchmark, the MSCI EAFE (Europe, Africa, Far East) Index. The top 10 positions show modest change. Vodafone (the number of shares increased 52% to \$1.1 billion, 3.2% of the portfolio) since the start of 2010 jumped to third, while Schlumberger and Lafarge, though their share counts remained constant,

dropped out of the 10 largest holdings.

Additions to the portfolio lately have increased telecom with modest buys in Telekom Austria (\$5.1 million, 0.01%) and Bharti Airtel (\$14.9 million, 0.04%) and a bump up in the already significant Vodafone position. Notable increases occurred in Dutch insurer Aegon (up 51% to \$438.7 million, 1.1%) and Germany's Bayer, the drug company, (up 18% to \$873.4 million, 2.3%). Reductions were few and at the margins. For instance, Toto, the Japanese plumbing company, a small position, decreased by 82% to 0.03%.

Although American investors since the market took off in March 2009 have been at best tepid in their purchases of domestic mutual funds, interest in foreign funds has been stronger. Lately, however, concern that Europe was not keeping up with America's economic recovery, which the shaky so-called PIIGS (Portugal, Italy, Ireland, Greece, Spain) highlighted, is spooking not just American investors but the entire world. DODFX year to date is off 2.1%, while the average large cap international value fund as tracked by *Morningstar* has dropped 4.8%.

As of the end of March, with the European crisis well under way, DODFX had not changed its geographical mix significantly: Europe (46.8%) and the United Kingdom (14.9%) still dominate. Note that Dodge & Cox International Fund, though it is able to hedge its currency exposure and did so for a brief period several years ago, currently is fully exposed to changes in exchange rates. If you believe that the dollar at present is overvalued and will weaken in the future, DODFX's unhedged position would boost performance.

Compared to the 362 international large cap value funds *Morningstar* monitors, DODFX has an excellent record: up 26.8% (vs. 18.2%) over the last 12 months, over the last three years -7.4% (vs. -10.3%) and 5.1% over the last five years (vs. 2.4%). DODFX ranks seventh for the last year and sixth over the previous five years.

**Third Avenue Value Fund (TAVFX)**, this shop's flagship, is not beating its benchmark. Down 4.9% this year, the average large-cap value fund *Morningstar* tracks has added 0.2%. Such a divergence, even if we still are just a third of the way through the year, merits discussion. Beginning last September TAVFX started to see outflows, perhaps in response to a change in how the fund is managed. In July, Third Avenue had announced that Marty Whitman, who founded Third

Avenue and whose investing methods and discipline infuse its funds, would be joined by Ian Lapey as co-portfolio manager, and would play a less active role.

Whitman, like Buffett at Berkshire Hathaway, is so identified with his firm that the very idea of either man not being in control of his company's direction gives investors pause. We believe that Buffett has settled the succession issue at Berkshire, and are even more confident that the methods and discipline Marty Whitman developed at Third Avenue can be replicated by Lapey and other fund managers Whitman has brought along.

Third Avenue's devotion to what Whitman characterizes as "cheap and safe" investments with ultra strong balance sheets that understate asset values has taken the portfolio to East Asia and Japan, especially toward holding companies, which inherently are trickier to analyze. Currently 28.9% of the portfolio is invested inside the United States. 40.3% is invested in Hong Kong, 10.1% in Japan and 7.3% in South Korea. In each of the last two countries, the entire position is represents a single investment: Toyota Industries in Japan and POSCO Steel in South Korea. None of these foreign positions is hedged against currency risk, though because the Hong Kong dollar is pegged to the U.S. dollar, currency risk there is minimal. How many funds that are categorized as domestic value funds have so strong an exposure outside the United States?

In August 2009, the last time we discussed the fund in any detail, TAVFX had 22.8% of assets in East Asian holding companies with considerable exposure to real estate both in Hong Kong and China. Also, about 11% of the portfolio represented Toyota Industries, a holding company that has 6.4% of its assets in Toyota Motors.

As of January 31st, exposure to Hong Kong holding companies has declined negligibly and the number of shares in Toyota Industries is up 1.1%, though given the 14% decline in the car company's share prices Toyota Industries accounts for only 10.1% of assets. Even after this hit, Toyota Industries trades, according to Third Avenue's analysis, at a 20% discount to its portfolio of shares in Toyota Motors and other businesses, which means that Toyota Industries' operating assets are valued at less than zero. Such distortions give Third Avenue that "cheap and safe" cushion it needs to weather difficult passages.

Most recently the fund in order to meet share redemptions has had to reduce some positions. With one glaring exception, Lapey and Whitman were raising cash, not cashing out of positions they concluded were mistakes. Selling 5.2% of Henderson Land Development, for instance, hardly dents that investment, while the other trimmed positions were quite small to begin with. The glaring exception was Ambac, one of several bond insurers that Third Avenue bought heavily in the wake of the 2008 Lehman bankruptcy. Though the shares were cheap and thus met one half of Third Avenue's requirement, they completely failed the complementary requirement: safety.

Ambac had pioneered municipal bond insurance during the 1970s and made the catastrophic decision to expand their repertoire to insuring collateralized mortgage obligations, some involving subprime paper. Third Avenue after the subprime fiasco exploded along with a couple of other shrewd institutional investors believed Ambac and MBIA, the second largest bond insurer, had enough balance sheet strength to weather the storm. They were wrong.

On the constructive side, the fund made a single new investment in KeyCorp, a bank holding company focused on the Midwest that took its lumps along with the rest of the industry post-Lehman as its portfolio of residential and commercial real estate loans suffered. Analysis of its balance sheet convinced TAVFX to buy 10 million shares at an average price of \$6. At today's close, KEY stands at \$7.88.

You learn more about fund managers during difficult times than during good times, which is another way of saying that what should count for any investment is its long-term record. From time to time Whitman and his colleagues bet big and lose as happened with Ambac and MBIA. Nonetheless, Third Avenue Value Fund's history places it among the best performers. As Ian Lapey, the co-portfolio manager notes in his first quarter report to shareholders, the fund over the so-called "Lost Decade" had an annualized return of 7.3% and from inception (11/1/1990) a 12.9% return, which places it among the top dozen large cap value funds tracked by *Morningstar*.

After 2009's extraordinary performance by high yield funds, it's hardly surprising that they most are idling so far in 2010. Until the market went south in late April, the star performers this year had been equities.

We think that distressed debt can hold its own. Since we introduced **Third Avenue Focused Credit Fund (TFCVX)** at the beginning of February, it's up 4.2%, which compares favorably to both existing high-yield ETFs and five high-yield mutual funds *Morningstar* lists as "fund analysts' picks." None of these funds over the same period has cracked 2%. In short, this Third Avenue entry is performing splendidly in part because its choices are working and in part because it was not burdened with lingering mistakes. Since the previous report to shareholders, the fund's assets under management had increased at the end of January to \$545.9 million from \$282.8 million at the end of October. Most came from cash inflows.

In the fund's most recent report to shareholders, composed in February and based on the portfolio as of January 31st (<http://www.thirdavenuefunds.com/ta/documents/sl/shareholderletters-10Q1.pdf>), Jeff Gary, the portfolio manager, acknowledges that last year's "easy money" is history. After so lucrative a run "there are various reasons to be cautious in the near term." Nonetheless, Gary has reason for optimism: the spread between high-yield credits and Treasuries continue to run higher than its historical average and investors, with pre-tax yields on other credit instruments at unnaturally low levels, continue to like the yields in below-investment grade debt. Also, twice in recent history (1990 and 2002), default rates had peaked as they did in 2008 above 10%. Each time the next year produced the highest returns for junk debt. Yet that was not the end. Over the next several years, strong positive returns persisted. From 1992 to 1997 and from 2004-2007 high yield debt prospered with the exception of 1994 when sharply higher interest rates took a 1% bite out of returns (versus a much heavier loss in Treasuries). Gary believes we have reason to be optimistic about the next few years.

We should add that if you are looking at this fund simply for above-average yield, you might miss a simple truth: Gary is as much interested in capital appreciation as he is in enhanced yields. We think there is a reason the fund does not use "High Yield" in its name and instead highlights "focused credit." Whitman started his career investing in distressed debt and expanded his analytic range to equities. This fund brings the Third Avenue story back to its

genesis.

Besides offering above average yields, distressed debt, particularly as cultivated by Third Avenue, has significant potential for asset appreciation. Distressed debt investing resembles equity investing and can respond to similar dynamics. The key for identifying such situations starts with analysts' intimate grasp of the specific debt's nuances and requires sufficient experience and imagination to anticipate the various

outcomes that might develop ranging from uneventful regular payments of interest and eventual payment of par at maturity to reorganization in bankruptcy.

In fact, the most lucrative outcomes arise when a company is forced into reorganization. For example, the fund reported in its initial letter to shareholders, prepared in early December, that as of October 31, 2009 it held about \$7 million (face value) at about a 35%

discount from par debt issued by CIT Group, which specialized in financing small to mid-sized companies' inventories. As Third Avenue composed that letter, CIT went into bankruptcy, from which it emerged in just six weeks. During that period, Third Avenue quintupled its holdings in CIT debt, anticipating correctly that after all existing common and preferred shares were wiped out, debt holders would receive a lucrative package of equity and debt in the new and improved CIT Group. Senior debt holders, like Third Avenue, got a combination of new shares (30% of their debts' face value) plus new senior unsecured debt (70% of face value). With its balance sheet now pristine, CIT's new debt is highly secure and the equity portion since coming public on December 10th is up 43%.

According to the October 31, 2009 report, the fund, was 28% in cash and cash equivalents, not surprising since it had opened just two months before. Despite the influx of nearly \$160 million in new cash during the next quarter, Gary and his team had reduced the cash position to 17%. It's worth noting that the new credits added to the portfolio during that quarter represent the riskier end of the spectrum: distressed performing credits and debt-for-equity restructuring. Don't jump to the conclusion that the fund is overreaching in search of big payoffs. Instead, view this as Third Avenue applying its expertise to maximum benefit. We have no qualms about how Jeff Gary is sculpting the portfolio.

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The now fashionable view that Buy and Hold no longer is viable, which is another way of advocating trading in and out of positions, does not convince us. We believe there are valid reasons for long-haul investing either because we continue to see future profit in investments that show success, or remain confident that the pay-off for a yet unsuccessful investment is substantial enough to justify absorbing the pain.

## Portfolio Updates

Never has the “Sell in May and Go Away” mantra sounded so seductive as it did at the end of this month’s first week of trading. We’ve been here before and used such breaks to our benefit. Our indicators remain bullish, which is to say, the U.S. economy is still in the early stages of recovery from the deep recession that emerged in December 2007 and bottomed in late summer or early fall of last year. There should be plenty of life left in the resurgence of stock prices even after the mammoth rally we’ve enjoyed. Since we priced the April letter on April 2nd, the Dow has declined 5%, the S&P and the Nasdaq 5.7% and the pan-market Wilshire 5000 5.6%. *Sound Advice* dropped 6.5%.

**Telecom New Zealand**, the April recommendation, reduced its own sales projections for the next fiscal year but maintained its estimates for the current year, which concludes on June 30<sup>th</sup>. Q3 results reflected the headwinds noted in our recommendation: the slow recovery from recession, increased competition and the costs, both financial and reputational, from the repeated system failures of its recently rolled out 3G mobile phone network. Management will maintain the current dividend, though next year’s distribution depends on how much NZT can improve its revenues and cash flow. NZT is off 5.6%.

**Transocean** shares have had the hardest month after its Deepwater Horizon drilling rig exploded and sank in the Gulf of Mexico with the loss of 11 workers. As horrendous as that loss is, a much broader tragedy is playing out as hundreds of thousands of gallons of oil spewing from several subsea breaks are now starting to wash into coastal estuaries. From where RIG stood when the platform exploded on April 20th, shares are off 26% (23% since the last letter), a loss of \$3.2 billion in market cap. This catastrophe’s enduring impact on RIG will be far less than what the market has declared. Transocean has lost income from its contract with BP, which had leased the Deepwater Horizon for about \$500,000 a day. The platform itself is a total loss and it will take a couple of years for a replacement to be designed and deployed. There will be lawsuits. Most of all there will be a massive cost for abating and then cleaning it up. However, Transocean is insulated from most of the liability. As Transocean’s 10K notes: “Consistent with standard industry practice, *our customers generally assume, and indemnify us against, well con-*

*trol and subsurface risks under dayrate contracts* [our emphasis]. These are risks associated with the loss of control of a well, such as blowout or cratering, the cost to regain control of or redrill the well and associated pollution. However, there can be no assurance that these customers will be financially able to indemnify us against all these risks.” BP is good for the costs. As investigations begin, the hypothesis is that work being done by a subcontractor, Halliburton, was the likely trigger for the explosion and that control devices provided by Cameron International failed and led to the massive pollution problem. Presume that Transocean will incur a billion dollars in costs and will lose \$500 million in revenue (numbers we believe overstate RIG’s exposure). This is less than half of the damage already done to its market cap. If Transocean is not financially endangered by the event itself, there is the question whether submarine drilling will be severely curtailed in the Gulf of Mexico and whether the expansion of drilling off the east and west coasts that President Obama greenlighted just a few weeks ago will be put on the back burner. Transocean operates 139 rigs, 14 in the Gulf of Mexico. Of the company’s 23 elite rigs that can work at depths of 7500 feet and deeper, 12 are in the Gulf. We suspect that after a cooling off period, existing rigs will resume work in the Gulf. Elsewhere around the world, the Deepwater Horizon story will have minimal impact. Yes, new regulations will impose new costs on Transocean, but these costs will be shifted to its clients. We think Transocean is an extraordinary opportunity for investors that can cope with investor confusion and anxiety. However, Transocean’s share price also has responded to forces beyond the Gulf of Mexico as natural resource prices have been pounded. **Fidelity Select Natural Gas** fell 11%, **Leucadia**, a holding company with significant exposure to mining, lost 9.8%, **Plum Creek Timber** is off 5.6%, **PowerShares Water Resources ETF** fell 6.4%, **Anglo American** lost 18%, though **USAA Precious Metals & Minerals Fund** rose 3.9%, which was accomplished against the crumbling dollar. Two factors explain the deeper losses among natural resource shares compared to the overall market. One tracks back to China and the other to the Greek financial crisis. First, China again is trying to cool its economy, especially out of control real estate speculation. Beijing is limiting lending, which forces those in-



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	\$7.11	6.75%	\$8.25	BUY
Telecom New Zealand	NZT	NYSE	\$7.44	10.70%	\$8.60	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$57.40	0.19%	\$76.00	BUY
CarMax	KMX	NYSE	\$22.23	0.00%	\$30.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$22.36	2.76%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$29.38	7.67%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$24.14	4.54%	N/A	BUY
Fastenal	FAST	NASDAQ	\$50.22	1.39%	<b>\$55.00</b>	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$17.50	1.89%	N/A	BUY
Honeywell	HON	NYSE	\$43.52	2.78%	\$49.00	BUY
International Speedway Corp.	ISTA	NASDAQ	\$28.00	0.50%	\$31.00	BUY
Johnson & Johnson	JNJ	NYSE	\$63.31	3.10%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$22.87	0.00%	\$30.00	BUY
Mattel	MAT	NASDAQ	\$21.45	3.50%	\$26.50	BUY
Microsoft	MSFT	NASDAQ	\$28.21	1.84%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$41.96	2.29%	\$52.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$18.98	0.00%	<b>\$25.00</b>	BUY
Stryker Corp.	SYK	NYSE	\$54.12	1.11%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$16.62	3.85%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$22.45	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$44.06	2.59%	N/A	BUY
United Parcel	UPS	NYSE	\$63.93	2.82%	\$70.00	BUY
UnitedHealth Group	UNH	NYSE	\$29.02	0.10%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$52.40	2.31%	\$60.00	BUY
Xerox	XRX	NYSE	\$9.73	1.77%	\$11.00	BUY
<b>Energy/Natural Resources</b>						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$18.50	0.00%	\$25.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.21%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$37.20	4.52%	\$43.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$16.43	0.49%	\$19.00	BUY
Transocean	RIG	NYSE	\$68.01	0.00%	<b>\$85.00</b>	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$36.41	0.03%	N/A	BUY
<b>Aggressive Growth</b>						
AOL Inc.	AOL	NYSE	\$21.76	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$6.38	0.00%	<b>\$10.00</b>	BUY
Comcast	CMCSA	NASDAQ	\$18.36	1.78%	\$21.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	8.16%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$45.51	7.14%***	\$50.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$9.63	6.65%	<b>\$10.65</b>	BUY
Liberty Global	LBTYA	NASDAQ	\$24.06	0.00%	\$32.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$18.50	4.32%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$15.62	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd***	TFCVX	800-443-1021	\$10.81	2.20%	N/A	BUY
Time Warner	TWX	NYSE	\$30.25	2.51%	\$34.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$41.32	0.00%	N/A	BUY

\* Prices as of Friday, May 7, 2010

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

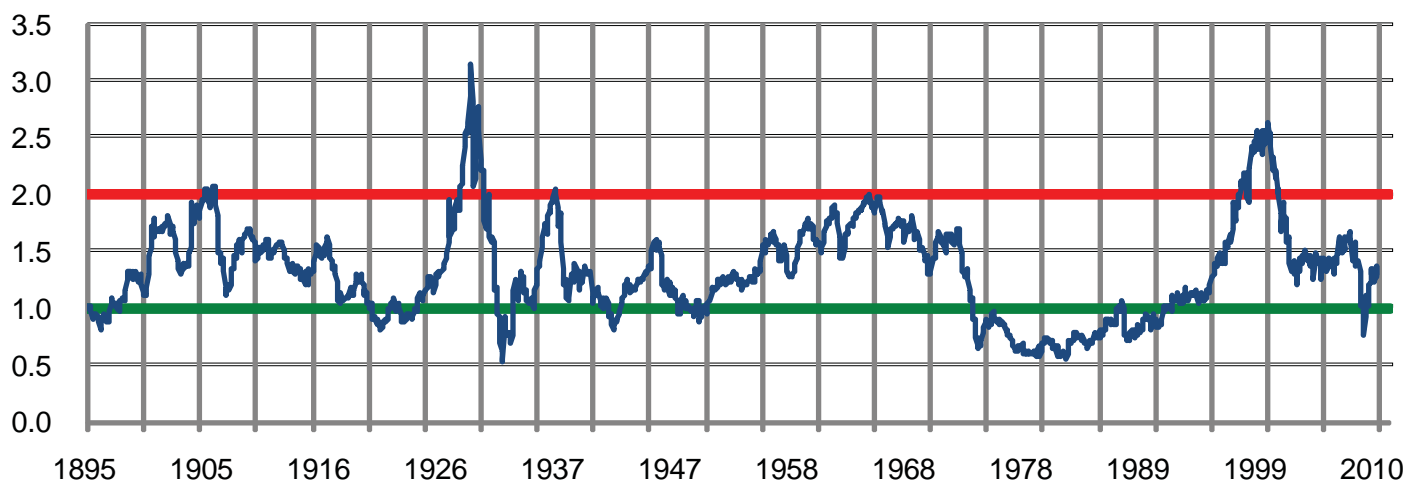
\*\*\* Dividend Deferred

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

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

vested in the notion that China will pull the world out of recession to question whether any deceleration of its economy would doom their expectations. And then there is Greece. If it were to default on its government debt, the consequential damage to European economies could curtail economic recovery not only in Europe but in every country that trades with Europe. Were that growth story to die, as is the concern with a braking China, so too would anticipated demand for oil, copper, coal, iron and every other commodity. Second, as fears that not just Greece but other weaker Eurozone economies, the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain) were at risk, the Euro cratered, which also meant that the dollar soared. Since commodities are priced in U.S. dollars, a rising dollar mechanically meant falling dollar prices for these commodities. **USAA Precious Metals & Minerals**, even though gold is denominated in dollars and had risen over the last few years whenever the dollar weakened, ignored that relationship this time. Instead, investor fear drove cash into gold, what many are viewing as the ultimate refuge against devalued fiat currencies. Also as the Euro fell, investors shoved into U.S. government debt, testimony not to how potent the dollar is, but a confession of how weak every other western currency is now. During such panicky buying, yield was irrelevant. When we priced the portfolio in April, the yield on the 10-Year Treasury Note hit 4%. At the worst during Thursday's 1000-point implosion of the Dow, the yield collapsed to 3.27%, but on Friday hopped back to 3.43%, but still hurt the **UltraShort 20+ Treasury ProShares ETF (TBT)**, which since the last letter is down 15.6%. If the rest of the world falls into the dumpster, then perhaps this flight to the dollar makes sense—for a time. The Greek/Euro crisis, much like our own subprime crisis, had failed to rally government remedies until the consequences spread beyond Greece itself. On Mother's Day night, the Eurozone central banks finally are throwing their full weight against the Greek and related crises. By the time you read this, we expect that Treasury yields will have risen by 20 or 30 basis points and TBT will be significantly higher. This fund's performance will turn on U.S. interest rates, whose direction, we believe is higher, much higher. Our other bond investment, the **Third Avenue Focused Credit Fund**, that holds high-yield paper, was flat (-0.2%), an acceptable outcome, since when investors get anxious about risk, high-yield debt gets sold. For example, the five high-yield funds *Morningstar* favors averaged a 1.4% loss over the same period. Financial stocks also had a rough run as investors worried that just as in 2008 when the global economy

was hit by the subprime chaos and borrowing became nearly impossible after Lehman, should the Eurozone freeze up, lending globally might once more be hard. Certainly banks, especially European banks, were seen as vulnerable. The **Davis Financial Fund** lost 7.3% even though among its top 25 positions there is no exposure to European banks. That is not the case for the **Dodge & Cox International Fund**, which has more than half of its portfolio in Europe and the UK. See page 4 for more detail. **CGM Realty Fund** declined 5.5% and **HRPT Property Trust** 7.2%. HRP announced quarterly results that fit our expectations of continuing weakness in the commercial real estate market. Occupancy slipped less than 1% to 86.6% but newly acquired properties bought at attractive prices (CAP rates of 10%) cushion the weaker occupancy figures. Management, looking at an improving economy, expects no more than another 1% decline before expansion begins in the second half of the year. We are tantalized by HRPT's plan to invest \$80 million to acquire an Australian property owner. This is not a one-off. HRP sees Australia not just as a new market but as a bridge into Asia. Already the owner of a major industrial property on Oahu, Hawaii HRPT is weighing becoming active across the Pacific. Should that occur, HRP would take on a very different profile. We're happy to be a buyer of these finance-related shares. Healthcare stocks did not escape the slide. Other than **Odyssey Healthcare**, which added 3.7% as investors continue to see the potential for hospice care as a significant alternative to hospitalization, others were just part of the crowd. **Johnson & Johnson's** over-the-counter division got rocked when it recalled children's doses of several popular products, though JNJ declined only 3.7%. **Stryker** dropped 6.1%. **Hambrecht & Quist Lifesciences** declined 7.2%, though it has announced resumption of its dividend program that will distribute 5% of NAV each quarter. **UnitedHealth**, the HMO, fell 11.8%. Our argument for why UNH has a bright future because of healthcare reform is either just ahead of the curve, or wrong. UNH is a quality company in a despised industry. Eventually such mismatches work out to our benefit. **Boston Scientific** continues to wallow. Look on page 3 at who is keeping us company. Did anything other than Odyssey make money? **International Speedways** added 8.1% as it is getting ready to develop a casino-hotel at its Kansas City track. **Superior Industries**, which supplies parts to auto manufacturers, was up 4.7%. and **Fastenal**, the hardware retailer and wholesaler, was up 3.4%. Not much to crow about this month, but we think that the highs hit toward the end of April are not the end of this bull market. 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 1.27. 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 20 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.