

## A Tax Overhaul?



The *Sound Advice* Portfolio is up 3.2 percent so far this year, as compared to 6.5 percent for the S&P 500. We have an average profit of 69 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

In the last week of April, the Trump Administration released an outline of its tax overhaul plan. The plan proposes to lower the corporate tax rate to 15 percent, and would include personal "business" income generated from pass-through entities, such as Sub S corporations used by small businesses. Currently, Sub S income is taxed at the higher individual tax brackets. The personal standard deduction would be increased, but nearly all itemized deductions would be eliminated except for home mortgage interest and charity donations. Some sort of border tax is being considered, especially against countries that impose tariffs on the US. Plans seem to be moving away from the GOP plan that proposed eliminating tax deductions for all costs for importing goods into the US.

The Administration purposely did not release enough information about the details to estimate the economic impact of the plan. Mick Mulvany, the head of the Office of Management and Budget (OMB) said that they are not trying to hide the numbers, but because this is the first round of discussions, there is no way to score the impact on growth or the revenue effects.

### Portfolio Updates

The portfolio is currently designed with a cautious approach, as suggested by the "Caution" signal in force by the *Sound Advice* Diffusion Index of Lagging Indicators (page 11) which is telling us that interest rates will continue rising.

An additional reason for caution is because the market has made a stunning rise since Trump's election, anticipating the positive impacts of tax reform and new infrastructure spending. However, it is now becoming apparent that these proposals are still in conceptual stages and are not yet close to coming to fruition. The market is likely to be buffeted in the weeks ahead by political debates which will raise uncertainties regarding tax reform and infrastructure funding sources.

### Energy & Natural Resource Selections

President Trump's "America First Energy Plan" is aimed at giving energy independence to the US by unleashing America's \$50 trillion in untapped shale, oil, and natural gas reserves. Cost-cutting and the use of better technology in the US oil patch is making this goal more achievable. In the most prolific areas, which include the Permian Basin and Eagle Ford, drilling costs have declined below \$36 per barrel. As a result, shale producers have continued to drill and pump, as evidenced by the continued rise in record-high US oil supplies.

Increased production is only part of the solution in becoming energy independent. The oil needs to be refined and transported to areas of need. Prior to the US shale revolution, most US refineries were constructed to process heavy sour imported oil rather than the light sweet crude that comes from fracking shale. This has continued to drive demand for imported oil even though US supplies of oil from fracking are brimming in storage tanks. This problem is exacerbated by the fact that east and west coast refineries do not have direct access to the US crude oil pipeline network. This means they must rely on imported oil arriving in US ports. Accordingly, to become energy independent from importing oil, a more extensive pipeline infrastructure is needed, and refineries need to be converted. Both of these projects are in the wheelhouse of **Chicago Bridge & Iron (CBI)**. Among refineries, **Valero (VLO)** has advantages over its peers because its refineries have more flexibility to handle light domestic crude and have access to the current US pipeline network.

**Chesapeake Energy (CHK)** has a portfolio of close to 8 million net acres of oil and gas assets inside the US, in the Haynesville/Bossier, Marcellus, Eagle Ford, Powder River Basin, Utica, and Anadarko Basin regions. As purely a domestic producer, CHK is well situated to contribute to US energy independence. It is also protected from any new tax plan involving border adjustments or tariffs on imported oil.

Because oil brings three times more cash than gas on an energy equivalency basis, CHK is focusing on developing its oil producing properties. (We have been noting this inconsistency in these pages. See the chart on the next page.) CHK is planning 320 new crude wells versus 90 for natural gas. The company expects oil output to grow by 10 percent this year

with the goal of doubling it in 2018.

The consensus is that CHK will earn 65 cents per share in 2017. A price/earnings (P/E) ratio of 10 puts the stock at \$6.5. A P/E closer to the overall market of 15 puts the stock close to \$10.

**Chevron (CVX)** reported earnings at the end of April, of \$1.41 per share, sharply higher than expectations and reversing a loss of 39 cents one year ago.

CVX is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these stages of production, depending on the prices demanded for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. Conversely, when oil prices are low, profit margins expand from refining. Management has pronounced the annual dividend as “sacrosanct” which provides an attractive yield and limits the downside risk.

Chevron has a huge reserve base and production is set to increase in 2017 from several areas, including the Bangka project in Indonesia, the Alder project in the North Sea, and from both of the large Australian LNG projects; the Gorgon and Wheatstone. Inside the US, the company’s 2 million acres in the prolific Permian Basin will be an important area of focus in 2017.

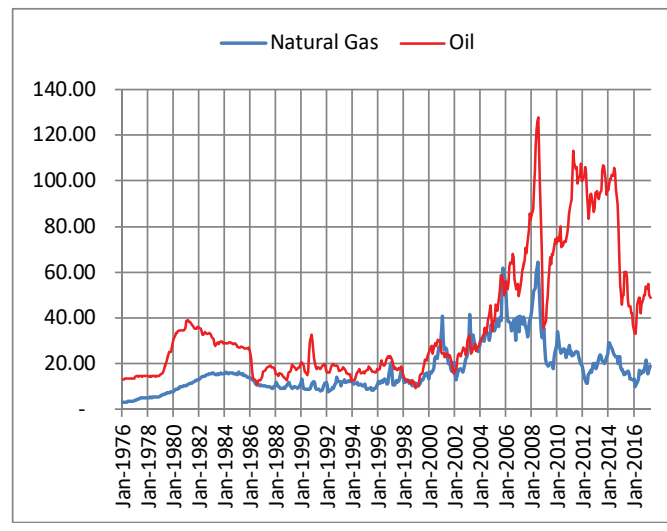
**Chicago Bridge & Iron (CBI)** is in our energy section because most of its earnings come from energy-related projects.

CBI has three operating segments offering specialized services that are often integrated for large complicated projects. In 2016, close to half (47 percent) of the company’s operating income came from its Engineering & Construction segment, primarily energy-related. Twenty-eight percent came from the company’s Fabrication segment, which makes steel-plate structures used in liquefied natural gas terminals, electric power-plant projects, and pipeline systems for both water and energy substances. Sixteen percent came from the Technology segment which provides proprietary engineering services primarily for the petrochemical and refining industries. Conversion of US power plants from burning coal to clean-burning natural gas is also in CBI’s wheelhouse.

Nearly all (90.4 percent) of CBI’s operating income is generated from clients in infrastructure-related industries, and energy-related infrastructure projects are CBI’s specialty. Accordingly, CBI is well positioned to benefit from increased US infrastructure spending and expansion, especially for the energy sector.

Trump’s election sent infrastructure stocks soaring; including CBI which climbed from \$28.56 before election-day to \$36 in mid-February. Since then, the stock has retraced that gain. Chief Financial Officer, Michael Taff, expects CBI to generate earnings between \$4.00 and \$4.60 a share. At the low end of this range of \$4.00, the stock is selling at less than 8 times earnings.

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



Currently, the overall market, as measured by the S&P 500 index, is trading at a P/E ratio of close to 18, based on estimated earnings for 2017. CBI’s P/E at less than 8 puts it at a steep discount to the overall market.

While Trump’s infrastructure and energy programs are still vague and long-term in nature, any boost in US infrastructure spending would offer a significant growth path for CBI and justify a much higher P/E, and thus a much higher stock price. A P/E of 15, which is close to the historical average for the overall market, based on earnings of \$4.00 would push CBI to \$60 per share – essentially doubling its current price.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the growth of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At the current price of \$50 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$3.15 for one million BTUs, 5.8 million BTUs will cost \$18.27. Thus, the same amount of energy is available for approximately 37 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

**ICON Energy Fund Class S (ICENX)** is also a diversified way to participate in the expansion of the energy sector with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sector to capture value, rather than simply depending on rising oil

prices. This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management.

**Freeport-McMoRan (FCX)** is the world's largest copper producer. Unfortunately, FCX acquired substantial oil and gas assets at the top of the market in 2013 and took on close to \$20 billion of debt to do so. To survive the downturn, the company has been selling assets to reduce its debt burden down to \$11.8 billion. Just as FCX was getting out of the weeds this year, it ran into serious problems with the Indonesian Government which wants to own 51 percent of FCX's giant Grasberg copper mine to be locally owned. FCX ceased production to gain negotiating leverage. Although the Government recently granted a 6-month permit to resume operations, it has instituted new rules that local mines operated by foreign companies must convert their Contract of Work to a special mining license, build smelters, and add local investors. This new, complicated uncertainty promises to drag on, putting a lid on FCX. **Accordingly, we are disposing of FCX.**

**Valero Energy (VLO)** is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland. Profitability in refining is a function of the so-called "crack spread", the difference in the amount a refiner pays for crude oil and the amount for which it sells the resulting refined products such as gasoline and jet fuel. Fluctuations in these prices compress and expand margins which can make refining stocks volatile at times. Valero is the most complex refiner in the US, which allows it to purchase lower quality crudes when they are priced at the most advantageous discounts. This flexibility allows VLO to capture the highest margins among its competitors.

Unlike most of its peers, Valero's refineries have access to US crude supplies and the flexibility to refine 600,000 to 1 million barrels per day of light domestic crude. Valero's refining flexibility, gulf coast locations, and access to the US pipeline network, give it an advantage over its peers.

VLO will also benefit from cheap Canadian oil that would flow through the recently approved Keystone XL Pipeline. Heavy sour crude oil from Canadian tar sands could move to Valero's Gulf Coast refineries capable of processing it, including facilities at Ardmore, Oklahoma, Port Arthur (near Houston), Texas City, the Meraux refinery in Louisiana, and its St. Charles facility. Along the Gulf Coast, the east plant of Valero's Bill Greehey Refinery in Corpus Christi can also process heavy, high-sulphur crude oil.

### ETFs for Rising Interest Rates

To stimulate the economy out of the 2008-09 melt-down, the Federal Reserve instituted massive bond-buying programs the three rounds of "quantitative easing.". The purchases added \$4.5 trillion of Treasury and mortgage-backed securities to the Fed's balance sheet. At the end of April, the minutes of the March Federal Open Market Committee (FOMC) meeting were released, which revealed that Federal

Reserve officials plan to begin shedding this \$4.5 trillion in bonds this year. FOMC members, including Chair Janet Yellen, noted that the move itself would amount to a rate hike.

The Federal Reserve is on the path of normalizing interest rates and its balance sheet, which means up-trending interest rates. To the extent the Trump Administration programs materialize, the combination of corporate tax cuts, infrastructure spending, deregulation, and repatriation of capital trapped overseas is bound to add upward pressure on interest rates. The era of historically low-interest rates is clearly over.

Our recommended ETFs, designed to benefit from the normalization of interest rates and long-term bond yields, differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

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.

The price action of these ETFs is based on the changes in long-term treasury bonds, as measured by benchmark bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. We have been using the Federal Reserve's prediction, which was as good as any. As part of the Federal Reserve's quarterly Federal Open Market Committee (FOMC) meetings, each of the 17 committee members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot".

The most recent Dot Plot was taken at the March 15 meeting. As usual, there was a wide difference in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end 2017, 2.125 percent at the end of 2018, and 3.00 percent at the end of 2019.

Monetary policy is generally a reaction to recent and past conditions. That is why the Federal Reserve is usually "behind the curve" when major economic shifts take place, and this current situation appears to be no exception. Accordingly, it is probable that the March Dot Plots will likely end up to be low. However, in the spirit of being conservative, we can use these Dot Plots as a basis of a forecast. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same yields as today's real return), long-term Treasury bonds would be yielding 3.58% by the end

### Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	21.49	6.1%	13.0%	6,558.5	43.84	-51.0%
Hospitality Properties	HPT	31.83	6.4%	10.1%	11,262.3	50.61	-37.1%
Hersha	HT	18.44	6.1%	9.1%	2,292.9	21.16	-12.8%
Host Hotels & Resorts	HST	17.95	4.5%	9.7%	20.7	24.19	-25.8%
Apple Hospitality	APLE	18.73	6.4%	7.9%	5,212.2	20.26	-7.6%

The table above shows the “Stock Market Cap Rate” (what the stock price is paying for the underlying real estate portfolio) for several comparable hospitality stocks. The “Stock Value” column shows the current value of the stock assuming the underlying portfolios are valued using a cap rate of 7.5 percent, which is close to the average cap rate on recent hotel transactions. The last column shows the discount or premium at which the stock is trading based on a 7.5 percent cap rate valuation of each company’s real estate portfolio.

of 2017, and 4.33% by the end of 2018, and 5.21% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$21.28 to \$29.50 by the end of 2017, to \$42.40 by the end of 2018, and to \$62.50 by the end of 2019.

TBT would rise from \$37.90 to \$47.13 by the end of 2017, to \$60.00 by the end of 2018, and to \$77.78 by the end of 2019.

TBF would rise from \$23.19 to \$25.75 by the end of 2017, and to \$29.00 by the end of 2018, and to \$33.10 by the end of 2019.

#### The Erosion Factor

As we point out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.04 percent (4 basis points) every day, and thus go nowhere through the end of 2017. Here is what would happen to each ETF:

TMV would decline to \$20.25 by the end of 2017 (4.9%).

TBT would decline to \$37.00 by the end of 2017 (2.4%).

TBF would decline to \$22.92 by the end of 2017 (0.8%).

While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

#### Real Estate Selections

Low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). As a result, commercial real estate prices are historically high. Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two currently exist in the hospitality industry.

The table above shows the comparative values of other hospitality REITs. **Hospitality Properties (HPT)** has the

second largest discount. However, this company is externally managed by RMR which charges high fees and suppresses value. As long as RMR continues to externally manage HPT, we do not expect to see significant growth. **Host Hotels and Properties (HST)** is very small, with only 749 thousand shares outstanding, which may lead to excessive volatility. Growth may be limited by its small capitalization. **Apple Hospitality (APLE)** is trading at a slight premium.

**Hersha Hospitality (HT)** is a real estate investment trust which owns and operates high quality upscale hotels in urban gateway markets. The Company’s hotels are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast. So far this year, moves to upgrade the portfolio include the sale of the Courtyard by Marriott in Alexandria, VA, and the Residence Inn in Greenbelt, MD. The sales were based on a 7.4 percent cap rate. The sale of the company’s suburban West Coast portfolio is anticipated to close in July, which is expected to fund a tax-deferred exchange to acquire the 153-room Pan Pacific Hotel in Seattle. The Ritz-Carlton in Coconut Grove, FL, was purchased this year.

During the last several years, Hersha has reported several hotel transactions it made at cap rates ranging from 5.4 to 8 percent. To be on the conservative side, we can establish a main street cap rate at the high end of this range, of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters’ financials, including the most recent 2016 fourth quarter, and using a 7.5 percent cap rate to evaluate the company’s portfolio, we value HT at \$23.23 per share which is significantly higher than the current price. The dividend yield is attractive and lowers the risk profile. Hersha is repurchasing up to \$100 million of its shares in 2017.

**RLJ Lodging Trust (RLJ)** is selling at a steeper discount to its hotel assets. RLJ has a large, geographically diversified portfolio of 125 hotels, branded by Marriott, Hilton, Hyatt, and Embassy Suites with over 20,000 rooms. Rather than traditional full service hotels, RLJ emphasizes “focused-service” or “compact full service” hotels, where only specially

chosen services important for guests are offered. The most important amenity is an attractive, modern room offering quality features for the basic necessities – sleeping, bathing, and working. Amenities such as large restaurants, spas, and meeting rooms are minimized. Overall, the hotels are mid- to up-scale, but with reasonably-priced rooms. This concept translates into a larger portion of revenue from the rooms. The company is on a mission to upgrade its assets by purchasing properties in high growth markets with barriers to entry. The company is also seizing opportunities to sell at high prices, such as the recent sale of two of its New York City hotels at a lofty 4.7 percent cap rate.

Based on the latest trailing four quarters' financials reported, including the most recent 2016 fourth quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at \$43.84 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

In late April, RLJ announced it will merge with Felcor Lodging Trust (NYSE: FCH). Each share of FelCor common stock will be converted into 0.362 shares of newly issued common shares of RLJ stock which translates to \$8.50 per FelCor share. The merge is expected to close by the end of 2017. Based on the 2016 financials using a 7.5 percent cap rate, the value of FelCor stock is \$12.32 per share, which makes the purchase price at a 30 percent discount. This is less than the discount of RLJ, but the merger creates a \$7 billion company. Both companies describe the combination as the "largest pure-play public REIT dedicated to owning focused-service and compact full-service hotels." The merger will expand RLJ's portfolio to 160 hotels with 31,467 rooms while adding locations on the West Coast and strengthening its presence in the eastern and southern US. The merger will save RLJ close to \$20 million in annual administrative expenses.

While the merger reduces the discount the stock is trading to its net asset value, the discount is still substantial. In addition RLJ has gained a larger, more diversified portfolio in a single stroke.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** has a number of distinguishing characteristics. This is a global real estate fund. Management looks for growth more

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

TVRVX is loaded with good values substantially below NAV with strong growth prospects. Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

### Medically-Related Selections

The cloud of uncertainty still blankets the health care industry. How long it will take to repeal and replace the Affordable Care Act (Obamacare) is anyone's guess. It is too early to look for new investments in this area.

Aside from Obamacare, Trump is dogging pharmaceutical companies to lower prices. He also wants to repeal the law that forbids Medicare from negotiating drug prices. For these reasons, our portfolio is conspicuously void of pharma stocks. We are comfortable with our current recommendations in this sector based on their own individual merits.

**Boston Scientific (BSX)** reported earnings of 30 cents per share in April for the first quarter with strong revenue growth in all regions and across all segments. The Cardiovascular segment revenues increased 7.7%, and MedSurg segment revenues improved 14.7% to \$782 million.

BSX produces medical products well suited for an aging population. 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.

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**Stryker (SYK)** reported earnings in April of \$1.48 per share for the first quarter of 2017, comfortably beating expectations, and considerably above the \$1.24 from one year ago. The largest segment, Medsurg (44% of sales) saw sales climb 10.8%. Orthopedics (38% of sales) increased 7.2%. The Neurotechnology and Spine segments (17.4% of sales) increased 5.3%. For 2017, the company expects adjusted earnings to be in the range of \$6.35 to \$6.45, with organic sales growth of 5.5% to 6.5%.

SYK provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, although SYK is best known for its orthopedic devices for artificial knees and hips. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase (and obesity trends continue), more and more hip, knee, and spinal procedures will be needed. Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions.

**Tekla Life Sciences Investors (HQL)** offers the most explosive profits in the healthcare industry with biotech companies. Over the last 15 years, biotechnology has become a major industry and the source of the world's top breakthrough drugs. Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

In exchange for lowering drug prices, Trump is promising to streamline the approval process for new drugs and treatments, which would be a substantial benefit to this sector.

### Financials

**JP Morgan Chase (JPM)** was added to the *Sound Advice* Portfolio in our mid-April email update because the stock is cheap in comparison to the rest of the market, and for its growth prospects. The soft interest rate environment in recent weeks has caused all bank stocks to pull back from their zeniths 6 weeks ago. JPM has declined nearly 10 percent, providing a timely buying opportunity.

With \$1.4 trillion, JPM holds the largest deposit base of all US banks. It is the largest issuer of credit cards. JPM's investment banking business leads the world as the largest generator of fees. The non-banking subsidiaries also contribute to the company's moat. Eight-three percent of the company's mutual funds produced above average returns. Only BlackRock and UBS controlled more client assets in 2016. This diversified array of businesses offers stable results and provides opportunities for cross-selling.

JPM has maintained solid capital levels and has a strong balance sheet. The company has a common equity "Tier 1 ratio", well exceeding minimum requirements. JPM did not have a losing quarter during the 2008-09 meltdown.

In April, JPM reported first quarter earnings of \$1.65 per share, well above the consensus estimate of \$1.51. This was a 22 percent increase from one year ago. The higher first quarter result increases the earnings estimate for 2017 to \$6.66 per share. At \$87 per share, the 2017 P/E ratio is 13, as compared to the overall market of 18.

Strong growth is expected in the immediate years ahead. JPM is expected to earn \$7.55 per share in 2018 and \$8.44 in 2019. At a P/E of 15, JPM would be \$100 per share by the end of 2017, \$113 by the end of 2018, and \$126 by the end of 2019.

These estimates are likely to be low because the benefits of potential regulatory changes and rising interest rates are not yet defined and cannot be baked into estimates. JPM's dividend has recently increased to \$2.00 annually, which puts the current yield at close to 2.3 percent.

**Wells Fargo (WFC)** has lagged in the bank rally because of the scandal regarding unauthorized account-opening practices. While there may still be some fall-out, management has changed and the issue is history. As with other banks, WFC will be a beneficiary of rising interest rates, and deregulation could expand business opportunities. Trump's campaign promises and subsequent executive order to loosen bank regulations in order to promote lending is a positive force for the banking industry. The relatively low price of WFC makes it a strong value and a timely investment. Even without the deregulatory benefits, WFC's 2017 earnings are expected to be \$4.45 per share, which yields a P/E close to 12. This P/E is too low for a growth stock. **Small Caps**

Small caps are typically not buffeted by the currency fluctuations that often haunt larger companies because they tend to be domestic companies without substantial overseas exposure. Numerous studies show that small caps perform better over the long run than the market as a whole. 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 quite profitable.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)** invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively

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estimated net asset value (NAV), and the ability to consistently grow NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

### Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

**Arconic (ARNC)** manufactures specialty metal products for aerospace and defense, building and construction, and automotive industries. Arconic is one of only a few companies with the expertise and assets to use uniquely advanced metallurgical techniques to produce metals that can withstand harsh environments, such as within a jet engine, as well as other vital uses in products that must not fail.

In April, ARNC announced that it will pay off debt with the exchange of the last of its 13 million shares of Alcoa. Revenue for the first quarter came in at \$3.2 billion, up 4.5% from a year ago with volume gains across all segments. Net income was \$169 million, excluding special items, or \$0.33 per share.

**Apple (AAPL)** was added to the portfolio when the demise of Samsung's latest Galaxy Note 7 phone flung open the doors for a significant new growth path. Samsung has been Apple's fiercest competitor, with 22.4 percent of the market share of smart phones – nearly double that of Apple's 11.8 percent share. Slightly more than one-half of Apple's revenue comes from its iPhones, so a gain of just one percent in market share translates to 14 million iPhones, which would add 7 percent to revenue. In addition, the new *iPhone 7* and *7 Plus* have been well received which is inaugurating a long-awaited upgrade cycle. The next scheduled upgrade cycle is the iPhone 8, which is rumored to recognize the face of its authorized user, and offer a larger screen through a reduced bezel..

Apple has a pristine balance sheet, with as much cash as long-term debt. The company carries the highest A++ financial ratings.

The Trump administration's proposal to lower the corporate tax rate to 15% would be a benefit for Apple, which has \$230 billion overseas, the most of any US company. CEO Tim Cook said he would be willing to bring that money home if it were not subject to the current U.S. corporate tax rate of 35%.

**Conduent (CNDT)** was spun off from Xerox in January. CNDT is basically the company that XRX purchased in 2010 called Affiliated Computer for which Xerox paid \$6.3 billion and assumed \$2 billion of debt. At the time of acquisition, Affiliated Computer had \$6.5 billion in sales and an operating margin of 10.5 percent. After 6 years of mismanagement, the operating margin dropped in half with no growth in sales. Still, this was the growth side of the old Xerox, with expertise in transaction-intensive processing, analytics, and

automation. This side of the business had an 86 percent contract renewal rate.

Now, as a stand-alone company, with fresh new management and specific growth goals, CNDT is basically a turnaround company with upside. Carl Icahn holds 9.77 percent of the stock which means he has influence and a reason to see growth. Icahn has 3 directors on the 9-person board with a focus on shareholder performance.

**International Business Machines (IBM)** is turning into a growth stock because of its artificial intelligence division based on Watson, the Company's super computer that can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. We have only begun to see and imagine the uses of artificial intelligence. IBM is the leader in that field and on a solid path to provide a growing abundance of opportunities in the months and years ahead.

In late April, IBM reported mixed first quarter earnings which caused the stock to drop 10 points to 160. We believe this provides a buying opportunity. Sales fell short which was the primary disappointment. Although revenue declined only marginally by 3 percent, it continued a string of 5 years of declining year-over-year quarterly revenues. However, overall earnings increased by one percent to \$2.38 a share, which was within expectations.

IBM ramped up R&D spending during the quarter to \$1.53 billion from \$1.46 billion a year ago. The 100 year-old legacy technology company is reorganized around "strategic imperatives," which include businesses like cloud, analytics, mobility, and security. These strategic imperatives grew to represent more than 40 percent of total revenue. Strategic imperatives revenue grew 12 percent to \$7.8 billion in the first quarter while cloud revenue grew 33 percent; led by cloud services which were up over 60%.

According to IBM executives on the earnings conference call, business is likely to pick up in the second half of this year, as the company wraps up last year's acquisitions, releases new products, closes on large contracts, and moves toward better profit margins.

In April, IBM raised the quarterly dividend for the 22<sup>nd</sup> year in a row. The 10 cent increase puts the quarterly dividend at \$1.50, which at the current stock price puts the annual yield close to 3.75 percent.

IBM is a good value now. The company expects 2017 earnings to be "at least" \$11.95. Other analysts are estimated to be in the vicinity of \$13.80. At \$160 per share, \$12 earning per share puts the price/earnings (P/E) ratio at 13.3. At a P/E of 15 puts the stock at \$180. At earnings of \$13.8, a 15 P/E puts the stock over \$200. At today's market P/E of 18 puts the stock close to \$250 per share.

**NCR Corp (NCR)** reported first quarter earnings in April of 56 cents, which was well above expectations of 46 cents. We added NCR to the portfolio when it was close to 10 times

earnings. NCR has climbed substantially, but it is still selling below the market average P/E ratio.

NCR makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world. NCR is experiencing strong growth in both its Software and Hardware segments. The software side is expanding its cloud and software license offerings while the hardware side is seeing strong demand for its Self-Checkout and ATM edge platforms.

The company now anticipates 2017 earnings per share to be in the range of \$3.32–\$3.42. At a P/E of 15, the stock belongs close to \$50. At a P/E of 18, which is closer to the current market, the stock would trade close to \$60.

**Symantec (SYMC)** is the world's leading cyber security company offering the organizations strategic, integrated solutions to defend against sophisticated attacks across endpoints, cloud, and infrastructure. Symantec operates one of the world's largest civilian cyber intelligence networks, allowing it to see and protect against the most advanced threats. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In 2016, for example, after paralyzing computers by installing a virus known as ransomware, cyber criminals demanded increasingly hefty ransoms to free the targeted inflicted computers. On average, ransoms tripled last year. According to Symantec, the surge in cyber extortion has been fueled by the sale of ransomware kits, which sell for \$10 to \$1,800 in underground markets and make it easy for "wannabe" cyber crooks to get in the business. One kit, known as "Shark", lets users name their demand, which its creators collect from victims and pass on to attackers, minus a 20 percent commission. Ransomware attacks have increased sharply, targeting hospitals, police departments and other providers of critical services. Hospitals have been forced to divert patients to other facilities when ransomware paralyzed computer systems.

SYMC is a turnaround situation, fueled by the disposition of under-performing past acquisitions and making new ones, particularly LifeLock and Blue Coat. Management's focus in 2017 is to perpetuate and integrate the synergies of these new acquisitions into Symantec's operations. LifeLock's identity theft solutions add new growth dimension to SYMC because consumers pay two to three times more for identity protection than for endpoint malware protection.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. The

acquisitions of Coffey and INDUS corporations have swelled TTEK's backlog of contracts and increased prospects for more Federal contracts in the IT sector. The company's backlog is now \$2.3 billion, which reveals a robust pipeline with major government organizations like the US Department of State, US Army Corps of Engineers, and the US Air Force, which should continue to bolster growth. The Trump Administration's infrastructure plans are bound to unlock additional opportunities for Tetra Tech.

In April, TTEK was awarded another contract for environmental remediation of radiological contaminants at various Navy and Marine Corps installations in California, Arizona, Nevada, Colorado, New Mexico, Utah, and other locations throughout the United States.

**Xerox (XRX)** reported disappointing earnings in April for the first quarter of 15 cents per share down from 18 cents per share in the year-ago quarter, which were impacted by restructuring costs of \$110 million from spinning off its business services unit to **Conduent (CNDT)**.

XRX should benefit from new separate leadership and goals,

and better focus and execution under its new CEO, Jeff Jacobson, who is bringing a new enthusiastic corporate culture and a three-year strategy for growth. Xerox is rolling out 29 new products aimed at mid-size companies which are stronger growth targets than large-scale businesses. An area of focus is "smart-label" technology directed at food and drug companies. Smart labels are printed electronic circuits that allow items to be identified and tracked in real time. They can be produced for a fraction of the cost of silicon sensors and used on small packages. This is a wide-open and high-growth market.

Company management expects 2017 earnings per share to range from 80 to 88 cents per share. XRX is still cheap relative to the rest of the market at less than 10 times earnings, especially with new growth paths to be implemented under the watchful eyes of Carl Icahn who holds 9.77 percent of the stock. The dividend yield is also attractive.

### Hedging the Portfolio

Our **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) is warning us to be cautious. Accordingly, we are also recommending a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500.

The **ProShares UltraShort S&P 500 (SDS)** is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

### SoundAdvice Investment Returns

Calculated Independently by the  
Hulbert Financial Digest

SoundAdvice in 2016 = **18.69%**  
vs. S&P 500 = 9.54%

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SoundAdvice from 2000-2016  
= **10.30%** Annually  
vs. S&P 500 = 2.37% Annually

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$5.26	0.00%	BUY	\$6.80
Chevron	CVX	\$106.70	4.05%	BUY	\$120.00
Chicago Bridge & Iron	CBI	\$30.08	0.93%	BUY	\$35.00
Fidelity Select Nat. Gas Fund	FSNGX	\$25.58	0.48%	BUY	\$28.00
<b>Freeport-McMoRan</b>	<b>FCX</b>	<b>\$12.75</b>	<b>0.00%</b>	<b>SELL</b>	
ICON Energy Fund Class S	ICENX	\$12.33	0.44%	BUY	\$14.50
Valero	VLO	\$64.61	3.71%	BUY	\$69.00
Real Estate					
Hersha Hospitality Trust	HT	\$18.44	6.07%	BUY	\$20.00
RLJ Lodging Trust	RLJ	\$21.49	6.14%	BUY	\$24.00
Third Avenue Real Estate Value Investor	TVRVX	\$32.75	0.50%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$26.38	0.00%	BUY	\$27.00
Stryker Corp.	SYK	\$136.37	1.25%	BUY	\$138.00
Tekla Life Sciences Fund	HQL	\$20.50	0.00%	BUY	\$22.00
Financials					
<b>JP Morgan Chase</b>	<b>JPM</b>	<b>\$87.00</b>	<b>2.30%</b>	<b>BUY</b>	<b>\$92.00</b>
Wells Fargo	WFC	\$53.84	2.82%	BUY	\$58.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$22.08	0.29%	BUY	\$24.00
Special Situations					
Apple	AAPL	\$143.65	1.59%	BUY	\$150.00
Arconic	ARNC	\$27.33	1.32%	BUY	\$31.00
Conduent	CNDT	\$16.31	0.00%	BUY	\$18.00
In't Business Machines	IBM	\$160.29	3.74%	BUY	\$170.00
NCR Corp	NCR	\$41.25	0.00%	BUY	\$45.00
Symantec	SYMC	\$31.63	1.01%	BUY	\$34.00
Tetra Tech	TTEK	\$43.95	0.82%	BUY	\$45.00
Xerox	XRX	\$7.19	3.89%	BUY	\$8.50
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$21.28	0.00%	BUY	\$25.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$23.10	0.00%	BUY	\$26.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$37.90	0.00%	BUY	\$40.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$13.19	0.00%	BUY	\$15.00

**Notes to the table:** The right hand column is the highest recommended price limit for purchases. Prices are as of 4/28/2017. See our website for live pricing and buy limits:

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

**General Comments:** 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, as we have done over the years, we assume another \$10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. 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.

As always, broad diversification will temper volatility, add to safety, and improve long-term performance.

## 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 under performing 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.

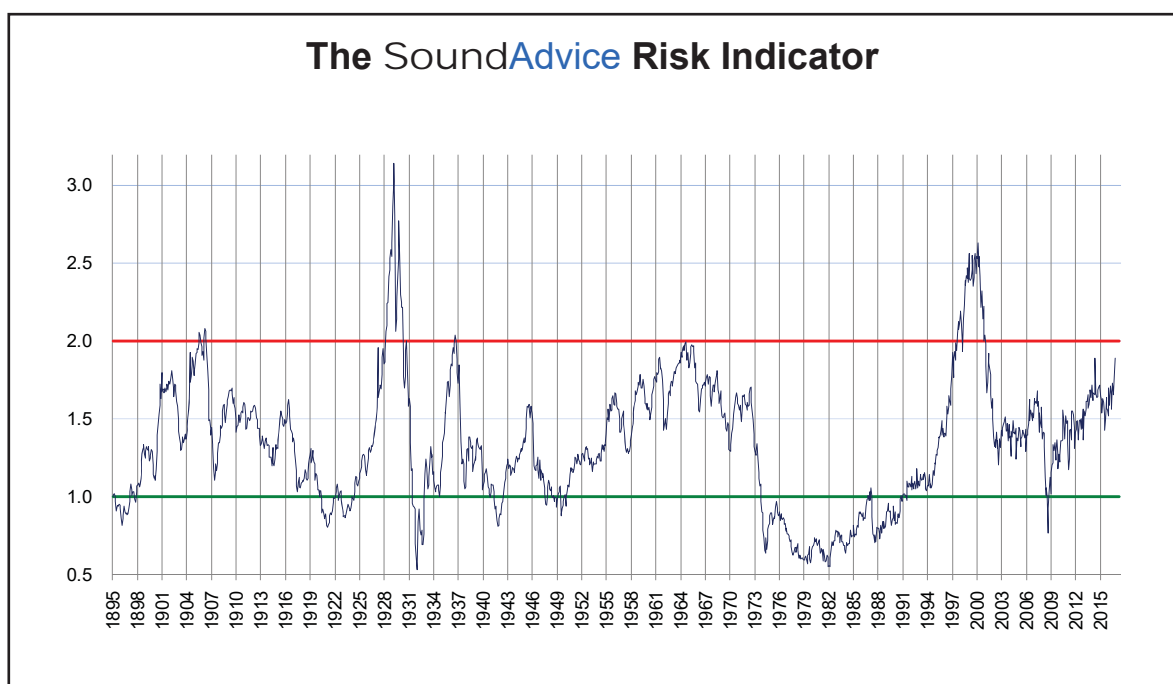
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$14 million in stocks and to \$1.56 million in houses.

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 \$557 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 latest reading for the SoundAdvice Risk Indicator is 1.89. 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 the Stock Market* for a complete explanation of the SoundAdvice Risk Indicator and its track record.



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

When the SoundAdvice Diffusion Index of **LEADING Indicators** drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the soft economy is providing an atmosphere for stable or declining interest rates.

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

The SoundAdvice Diffusion Index of **LAGGING Indicators** 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 reading reveals that the US economy is strong enough to put upward pressures on interest rates.

We have been operating under a "Caution" signal since the June 2015 release of the May lagging economic indicators.

The SoundAdvice Diffusion Index of **LAGGING Indicators** was **66.7 percent** in February (the most recent data).

Our next signal will come from the SoundAdvice Diffusion Index of **LEADING Indicators** when it drops to zero. The latest reading for February was **83.3 Percent**.

### 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 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 3.5 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.1%		3.5%

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Diffusion Indexes and their track records.

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