



Get ready for the pension crisis. Just as the mortgage fiasco required borrowers, lenders, rating agencies, regulators and the media to assume housing prices would never fall precipitously, employers and legislators, the regulators and the employees and their unions chose never to look at the long-term implications of the promises pension plans made. Labor contracts swapped future benefits for current costs and rather than using realistic rates of return relied on "political rates of return" that ignored reality. Nothing in this imminent mess befuddles me more than the rise of pension obligation bonds (POBs) issued by states to fund pensions. Playing the spread in bond rates is one thing, but it's another when, as New Jersey in 1997 did, the state plunks the cash into the stock market. Of course, 1997 wasn't a year that anyone saw risk in stocks. At the time, Christy Whitman, who was running for re-election as governor, pushed the POB, stock prices had been rising sharply for 15 years. A dollar invested at the start of 1982 in the S&P 500 by 1997 had become \$10.27. Who doesn't love free money? Who could argue that there was any risk at all in stocks? Certainly not the authors of *Dow 36,000* who at the same time Whitman was convincing the legislature that borrowing \$2.8 billion to play the market was prudent, were convincing themselves that stocks were riskless and that the Dow needed to more than double before it was fairly valued. In reality, risk was huge in 1997, and though the market would rumble on for another few years, the gains made then vanished in the bear market of 2000-2002. The next time risk was minimal was in early 2003, but I doubt any politician dared suggest a POB to bankroll a stock portfolio. The point for us is that risk is greatest when the market is humming along. It is least menacing when prices have been humbled. *Sound Advice* in both its macro and micro decision making starts with that mindset. Most investors find that too unnatural.

-Gray Emerson Cardiff

Earnings Season

We're approaching the end of second quarter earnings announcements, a time of seasonal volatility when the market reacts to corporate results and projections for coming quarters. Traditionally the kickoff announcement is from Alcoa, which this year fell on July 12th. On the whole, earnings came in higher than analysts had expected, which has kept the rally in equities that started in early July rolling. We can't look at each of the portfolio's 30 individual companies' reports, but a few offer insight in how Wall Street at a time of anxiety over which way the economy and hence the market are heading reacts to news.

Some companies reported numbers so obscured by special charges that they were unintelligible. For instance, **AOL** reported it had lost \$9.89 a share versus a profit of 86 cents in the second quarter last year. But if you stripped out special charges resulting from AOL's spinoff from Time Warner, AOL earned 66 cents, a quarter more than the 41 cents analysts had anticipated. Apparently pessimism about AOL's prospects set up the shares for a big bounce. On the news, AOL jumped 7.7% and is 10.7% higher since the last letter.

Boston Scientific did even better than AOL when it came to surprising analysts, who had expected earnings of three cents a share. Instead, **BSX** came in at 12 cents, which sets the stage for what could be the healing of this battered company. The next morning's conference call was upbeat and anticipated better times in coming quarters. But characteristically **Boston Scientific** management that same day also announced that there were potential problems with some implanted defibrillators, another legacy nightmare from the Guidant acquisition, and whatever good feelings the previous day's earnings news engendered vanished. **BSX** has moved up a bit since then, but shares are 10.2% under last month. Here we have a company that has shredded its reputation. Regardless of how well situated its products are for an aging population beset with cardiovascular problems or even hard evidence from the second quarter that new

The **SoundAdvice** portfolio is up **27.84%** since 1/1/2009

SoundAdvice vs the S&P 500

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

\$73,537
with **SoundAdvice**

\$23,135
with the S&P 500



management is improving the company, Boston Scientific's history begi

nnings with its exorbitant acquisition of Guidant in 2006 has conditioned Wall Street to expect the worst. For value-oriented investors with a high tolerance for volatility, BSX is a wager worth taking.

Ford also provided a positive surprise, but whereas Boston Scientific and AOL are pariahs for most of Wall Street, Ford is becoming a favorite. Instead of the 41 cents a share its common was supposed to earn, Alan Mullaly, the CEO, announced 61 cents and spoke optimistically about coming quarters and years. Ford shares ended our month up 20%. As for the Convertible Preferred in our portfolio, it added 13.8% and closed at \$47.21. At around \$17.70 the convertible begins to trade at a premium to the common based on the conversion rate (2.8249 shares of common for each preferred share), though since the preferred even at \$50 yields 6.5% and the common zero, there is an incentive for holders to not exchange their shares for the common until the Ford common is closer to \$20.

Agrium, which manufactures and distributes fertilizers, has lately been on a roll, and when it reported profits of \$2.90 a share versus the expected \$2.76, investors found another reason to push the shares higher. Since the last letter, AGU is up 14%. Here Agrium shares have hit the trifecta: global demand for food is rising again and commodity prices as well, reinforced by better earnings and further reinforced by headline news concerning wheat Russian export restrictions.

UPS, the shipper, did shock Wall Street by reporting earnings of 84 cents a share, nearly doubling Q2 from last year and exceeding analysts' expectations by 17 cents. In addition, management was optimistic about the balance of the year. Like Ford, UPS is a bellwether stock, but optimism at UPS is far more significant, since Ford's story depends on not just an improving economy but the car-maker's particular resurrection. UPS is a pure gauge for the domestic and international economies, so for it to surprise Wall Street means that it overcame the prevailing anxiety: the U.S. economy could be heading for a second round of recession. On the day, UPS shares soared 5.2% and for the month

are up 11.1%.

The take away is that surprises, especially for companies that are not well respected, can create a big jump, but that even when the companies project their good fortune into the future just modestly bad news, like Boston Scientific's defibrillator story, can poleax shares. And when a struggling company shows it's still struggling, as did Symantec, the effect can be harsh.

Let's close by moving from the micro to the macro, and consider why we remain bullish about share prices over the foreseeable future and expect an economic environment that will take companies like Symantec back to the black. On page10, we tally our indicators. You'll note that the sell indicator, our Diffusion Index of Lagging Indicators, remains silent. Of the three components we track, duration of unemployment for June, the last month the Conference Board reported in its July 22nd announcement, stands at 35.2 weeks, more than double where it stood at the start of the recession in December 2007. More significantly at least for our diffusion indexes that use the spread between the most recent number and where it stood six months before, six months ago the duration was 30.2 weeks. While the other components for the Diffusion Index of Lagging Indicators (the ratio of consumer credit outstanding to personal income and the change of CPI for services) point to an expanding economy, without confirmation from the unemployment component, the U.S. economy remains sluggish enough for us to expect more expansion in the future that should fuel better corporate earnings, more consumer spending and higher consumer confidence. As long as there are headwinds to restrain the economy and discourage investors, we are buyers. Are matters as gloomy today as they were when *Sound Advice* encouraged you in March 2009 to get more aggressive? Clearly not. But the remarkably meager employment situation is unlikely to change trend over the next few months, so we can't expect to get a Sell signal till autumn at the earliest and perhaps not even then. We believe that stock prices still have further to go. SA

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A Tale of Two Charts

The two charts on pages 4 and 5, illustrating two decades' divergent views on pharmaceuticals, focus on **Pfizer (PFE—NYSE)** as well as other major drug companies. The first covers 1994-1999, boom years for traditional drug manufacturers. The second covers the last decade, the so-called "lost decade," and shows big drug companies slightly underperforming the S&P 500, that is they went nowhere, while generics manufacturers like Teva and Perrigo boomed. It's not hard to see why investors in the 1990s were hooked on drug stocks like Pfizer. Thanks to new products and mergers Pfizer's sales increased year-over-year at a double-digit pace, peaking in 1999 when they jumped 20.1%. Cash flow that year leaped 27.5% and earnings 29.9%. Trouble hit in 2005 when every one of these metrics fell, but share price had been declining since 1999. At the peak share price in 1998, Price to Sales stood at 12.3, Price to Cash Flow at 54, Price to Earnings at 64 and Price to Book at 19—these were truly bizarre, manic numbers, the sorts of extreme pricing seen toward the end of investor frenzies.

A dozen years, two recessions and two bear markets later, Pfizer's share price has fallen 68% but underlying numbers for revenues, cash flow and earnings compared to 1999 returns have increased, albeit their rate of increase has slowed dramatically from the heady 1990s: sales are up 48% (based on 2009 results), cash flow 63% and earnings 41%. Changed also are investors' expectations about future growth: hence the feeble valuation ratios Pfizer currently carries. For instance, the forward P/E ratio based on 2010 earnings is 7.1. The trailing P/E 15.6—each is well below the historical average.

Pfizer is the world's biggest pharmaceutical company with sales of \$68 billion and a market cap of \$131 billion. Even after last year's purchase of Wyeth, the balance sheet is robust. It throws off prodigious amounts of cash, and has the wherewithal to dominate big pharma through organic growth. We believe at its current price Pfizer offers not just an attractive dividend with a current yield of 4.4% but also the prospect of considerable capital appreciation. But you don't get these opportunities unless investors hold a dim view of a sector's and/or

a specific company's prospects. Right now that view might be on the cusp of change.

Are We Back In 1993?

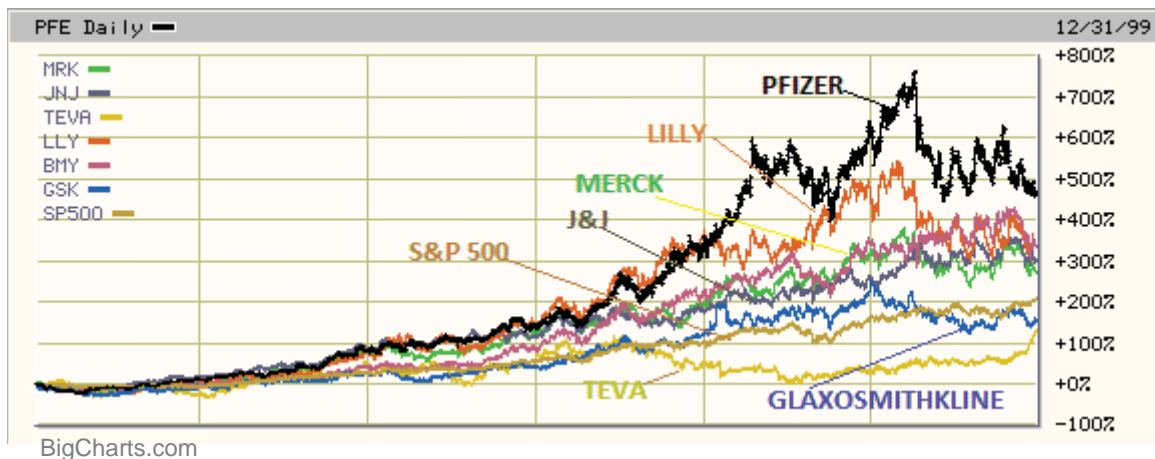
The mid-1990s surge was preceded by panic over what healthcare reform proposed by the newly installed Clinton administration would do to drug prices. Accordingly, major drug company shares, which had been rising earlier in the decade, bottomed in January 1993 just as the White House rolled out its healthcare task force. Defeat of that initiative kicked off five years of enthusiastic buying that carried drug companies' stock valuations to heights they'd never seen.

Seventeen years later, after refighting much of that healthcare battle that again had put the same downward pressure on healthcare shares, we have a different outcome. Over the next few years the number of Americans with access to regular medical care will increase substantially. Whatever restraints on pricing will come with greater government involvement, Sound Advice believes that the net result will be very favorable for pharmaceutical makers (and not just for them).

Big Pharma Today

The persistent weakness in big pharmaceutical companies' shares during recessions might seem paradoxical since healthcare is considered a defensive, safe-harbor sector like utilities and consumer staples, which are relatively insulated from the business cycle. You'd think that skittish investors would have taken shelter amid high-margin drugs. But drug companies are exposed to disruptive events that do not impact other defensive sectors. Drug companies can make mammoth, multi-billion dollar investments in clinical trials of new drugs hoping to come up with a blockbuster that for the life of its patent might yield billions in sales, only to have them fail in clinical trials or not receive FDA approval. Even when approved and marketed, negative effects not seen during clinical trials can emerge that either severely limit use of the drug or even result in withdrawal from the market. And even when a drug enjoys a robust sales history, eventually its patent protection expires, inviting generic drug manufacturers to swoop in,

Big Pharma: 1994 - 2000



siphon off sales and destroy profit margins. Imagine what would happen to Coke, for instance, if it lost exclusive control of its secret formula, or if Hershey could not market its Kisses? Drug companies face such challenges like clockwork.

Failed clinical trials can be devastating for companies like Pfizer, especially when the drug is being touted as the next blockbuster as was Torcetrapib five years ago, which was projected to produce as much as \$10 billion in sales, since it was a non-statin with the potential to lower LDL, the “bad cholesterol,” and increase HDL, the “good cholesterol.” Abruptly on December 2, 2006 Pfizer closed down clinical tests after a number of deaths and heart attacks occurred. PFE plummeted 10% on the next day of trading. No new testing has occurred.

IMS Health Inc, a market research firm, estimates that between 2009 and the end of 2013 global pharmaceutical companies will lose \$137 billion in sales as drugs fall out of patent protection and into generic production. Consider the calendar for expiring patents. In 2010: 10 major drugs will lose patent protection as will another 11 in 2011. Pfizer happens to own the biggest selling drugs among them: Effexor, an anti-depressant, goes out in 2010 with sales of \$2.8 billion and Lipitor, a statin with sales of \$6.4 billion, the biggest selling drug of all time, enters the public domain in 2011.

Next year, beyond Lipitor, Pfizer will lose patent control over Xalatan (\$1.7 billion or 3.5% of sales) for glaucoma and ocular hypertension. 2012 will be bad too: Detrol (\$1.2 billion or 2.3% of sales), used to treat overactive bladder problems, Geodon (\$1.1 billion or

2% of sales), used to treat bipolar and similar disorders, and Viagra (\$1.9 billion or 3.8% of sales), the king of impotence drugs, will lose patent protection. The next big Pfizer product to enter the public domain will be Celebrex in 2014 (\$2.4 billion or 4.8% of sales),

used to counter pain.

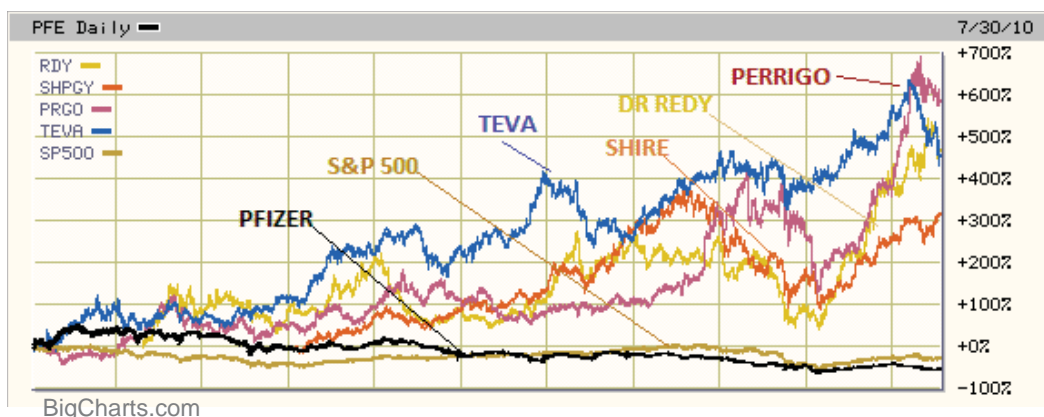
But it is the loss of Lipitor that has unnerved investors. However, by this point, it's hardly a secret that revenues from Lipitor and the other Pfizer stalwarts are about to evaporate. That is built into the share price. As they like to say on Wall Street: all of this is already “baked into” Pfizer's share price.

The Antidote to Patent Expirations

The obvious solution is for Pfizer to develop new products, particularly drugs with blockbuster potential, but that is an expensive and hardly foolproof. Lately, major pharmaceutical companies' investments in Research & Development are failing to pay off. On average it costs big pharma \$2.2 billion to develop and bring to market a new major drug, double what it did a decade ago. But based on R&D costs, pharmaceutical companies are creating 21% fewer new products. Indeed, just before Pfizer consummated its acquisition of Wyeth last year, it announced it was reducing its R&D staff by 8% and expressed frustration over how ineffective the program had been in generating useful products. When announcing the staff cuts, Pfizer said it wanted to focus on Alzheimer's, pain management and cancer treatments.

The more reliable solution for patent expirations and faltering R&D has been partnerships and acquisitions. The major pharmaceutical companies are providing cash, expertise and marketing prowess to smaller companies in order to gain access to their innovative products. A deal with Amgen, for example, gave Wyeth/Pfizer's reps a psoriasis product their

Pfizer and Generics: 2000 - 2010



own R&D could not provide. However, the most effective antidote for a shrinking line of lucrative drugs is to buy a competitor, preferably a big competitor, and gain both its existing products and its pipeline of drugs. Pfizer has a long history of making just this sort of mega-acquisition. It bought Warner Lambert in 1999 primarily to gain Lipitor and Pharmacia in 2003 to capture Celebrex, though in both cases, as with Wyeth, there were lesser products as well as drugs in the pipeline.

It's instructive to look closely at last year's \$68 billion acquisition of Wyeth, because it demonstrates the challenges that the biggest traditional pharmaceutical companies face: how to increase revenues and profits as older products lose their patent protection or become obsolete as well as the pitfalls: by combining peer businesses the acquirer assumes more of the same risks inherent in what they themselves already face: potential failed clinical trials, the discovery of problems in drugs already being sold and the eventual loss of patent protection for even the most lucrative products. Celebrex, the trophy drug from the Pharmacia acquisition loses patent protection in 2014, but already has forfeited a significant portion of sales after it was caught up in the same recall that resulted in the total withdrawal of Merck's Vioxx in 2004. Pfizer is still dealing with legacy civil suits over Celebrex.

Wyeth delivered to Pfizer five drugs with annual sales of \$1 billion or more. However, the biggest, Effexor (\$3.9 billion), used to treat depression, is already falling out of patent protection. Enbrel (\$3.8 billion), which treats psoriasis and was co-marketed with Amgen, its developer, faces a different problem.

Enbrel's patent expires in 2012. But because Enbrel is a biologic drug, that is it is developed using biological and not chemical methods, different FDA rules for generics apply, which makes development of a generic version much more difficult and hinders competition. Amgen and Pfizer get a bonus. Pfizer's contract with Amgen gives it co-marketing rights in

the United States and Canada (Pfizer has exclusive marketing rights outside the U.S. and Canada), but that agreement ends in 2013. Pfizer will receive more modest royalty payments in North America for the following three years. Like the energy industry, drug companies own wasting assets.

But the crown jewels Pfizer gained from the Wyeth deal are yet to hit the market. As Pfizer had said when cutting its R&D staff, its primary interest was in a treatment for Alzheimer's Disease. Several drug companies are working on the problem, but Wyeth along with an Irish partner, Elan, is furthest along with bapineuzumab, which is designed to remove from the brain beta amyloid, a protein, that triggers Alzheimer's most common symptoms. Recently Elan, in need of a cash infusion, sold its half interest to Johnson & Johnson for \$1.5 billion. If bapineuzumab makes it to market, it could generate \$5 billion in sales for the two companies within a couple of years.

Pfizer also has a growing list of future drugs, some of which will become lucrative products. The biggest is Prevnar 13, a reworked version of its own existing childhood pneumococcal vaccine, with potential annual sales of \$1.4 billion by 2014. There are another nine products either in Phase III trials or already approved with potential annual sales of \$3.4 billion. Beyond that there are literally hundreds of other products in earlier stages of development. Only a few of these will come to market, but they represent massive potential sales.

Amplifying the potential for sales of new drugs but also for those already sold is the expansion

of domestic demand that will result from greater access to health care over the next few years and surging demand from aging of the Baby Boom, a tide not just here in the United States. Last year, 10.8% of the world was 60 or older. By 2050 that will rise to 22%. Industry-wide projections for domestic drug sales are being moved higher. At the start of last year, a 1% to 2% decline thanks to the global recession was expected. More recently that has been revised to as much as a 4% to 5% expansion, which is in line with Pfizer's own expectations. Of perhaps greater significance, international sales, especially in Asia and other emerging markets, should expand, albeit from a much smaller base (North America and Europe accounted in 2008 for 72.3% of all drug sales). In the second quarter, total sales in emerging markets (+89%) had surged ahead of non-European developed markets (+42%), which more or less grew in line with European developed markets. Domestic sales increased 63%.

How The Wyeth Deal is Working Out

As we prepared this issue, Pfizer announced excellent second-quarter results that have given shares a boost. On the news, shares jumped 9% and as we close this issue, are up 10% from where they were when we began our research. Two facets of the quarter stand out. First, absorption of Wyeth and the anticipated synergies are making good progress. Cost savings were \$4 billion and ahead of projections. Second, revenues are rising for the company's core products. For example, sales of Lipitor increased 5%, Effexor 19%, Celebrex 7%, Viagra 12%, Zosyn 10% and Lyrica 20%. The animal health segment's revenues, which Wyeth products expanded, jumped 31% and the consumer products division, which entirely came out of Wyeth, also had a good quarter. Analysts had expected that Pfizer's per share earnings would come in at 52 cents on sales of \$16.6 billion. Instead, earnings came in at 62 cents on sales of \$17.3 billion. In addition to better raw performance, Pfizer was assisted by the re-weakening dollar that amplified foreign sales. During the conference call, management projected

We're not arguing for a replay of the 1990s when pharmaceutical shares outperformed the overall market, increasing seven fold. By the time they peaked in early 1999, valuations were out of sight. Were we to apply those bloated numbers, Pfizer would be in the triple digits. No, we'd be happy with the historical average low valuations of the last 16 years

that the year's results will hit the top of its range and that all projections through 2012 remain in place. Since rallying as high as \$16.70, PFE has settled back to \$16.24.

The share buyback program last quarter withdrew \$500 million worth of shares from the market at around \$16 a share. Management says it intends to continue to make opportunistic purchases. As for the quarterly dividend, which was cut in half to 16 cents to help the Wyeth purchase and in January was increased to 18 cents, management expects to increase it again in the fourth quarter, and within three years will bring the distribution back in line with its peers at about 40% of earnings (versus the current 33%). Based on current projections for 2010, that would translate into a 21 cent quarterly distribution or about 5.2%.

Finally, Pfizer, looking ahead to 2012, the first year without Lipitor under patent protection, anticipates profits won't dive. If the company can pull that off, it would surprise analysts who are anticipating a short fall of 8%.

Summary

We're not arguing for a replay of the 1990s when pharmaceutical shares outperformed the overall market, increasing seven fold. By the time they peaked in early 1999, valuations were out of sight. Were we to apply those bloated numbers, Pfizer would be in the triple digits. No, we'd be happy with the historical average low valuations of the last 16 years, which would translate, based on current sales, cash flow, earnings and book value, to a share price in the high \$20s, about 75% over its current price. Another measure of value, the dividend, even after being reduced to help acquire Wyeth, still produces a yield of 4.4%, which in a world of ultra-low interest rates in itself makes owning these shares attractive. If Pfizer can increase sales and earnings, or if the market becomes less hostile to the prospects for major pharmaceutical companies like Pfizer, the upper limit would move considerably higher, perhaps as high as \$40. At present, we recommend buying PFE up to \$19. SA

Portfolio Updates

Since we priced the portfolio on July 9th, a couple of strong days into the recovery in stock prices, the Dow has added 4.5%, the S&P 4.1%, the Nasdaq 4.2% and the pan-market Wilshire 5000 4.1%. The *Sound Advice* portfolio is up 4.8%.

The July issue's sector funds outperformed the market and the portfolio, advancing 5.7%. **CGM Realty Fund** added 8.6%. The **Davis Financial Fund** moved up 3.1%, while the **Gabelli Global Telecom Fund** added 6.1%. **Hambrecht & Quist Life Sciences Fund** tacked on 5.2%. The **Fidelity Select Natural Gas Fund** added 5.8%.

It's been generally a good month for natural resource stocks. Behind this resurgence are two factors: first, any reduction in fears about a relapse into recession is a positive for all stocks but especially for cyclicals like mining companies' shares. Also, the stock rally coincides with a weakening of the dollar (see chart on page 9) that boosts the value of any commodity denominated in dollars. **Anglo American** has reinstated its dividend with a 25 cent "interim" payment, which will go ex-dividend on or about August 18th. This is not a quarterly payment. Historically AAUKY has paid a progressive distribution, that is, the amount has fluctuated with revenues. The last time AAUKY declared a dividend was August 2008, just as natural resource prices began their headlong skid. Numbers from Anglo American created cross currents when they were announced: on the one hand, due to write-offs and taxes, income declined 31%, but revenues nearly doubled. Management continues to reduce its relative exposure to South African operations. Just as AAUK has sold off many of its peripheral businesses in order to concentrate on mining, it also has methodically disposed of assets in South Africa with the intention of becoming a global player. Since the last letter, AAUK is up 10.6%.

Leucadia, a holding company that for now is perceived as a mining company because of its current overweighting in that area, added 5.9%.

Plum Creek Timber, the timber REIT, eked out a 2.3% advance after coming in above analysts' expectations for the quarter but projected coming quarter results below the same analysts' calculations.

Tetra Tech, on the back of stronger than expected quarterly results, added 6.3%. The **PowerShares Water Resources ETF**, in which **Tetra Tech** is a primary holding (4.7% of the portfolio) added 3.8%.

Keep in mind that despite the fund's name, there are precious few companies that are exclusively in the water business. PHO, though it continues to distill its portfolio to emphasize water services companies, still has a very strong industrial flavor, since many of its holdings derive only a portion of their revenues from water-related businesses, while earning most of their revenues from other activities.

USAA Precious Metals & Minerals Fund, despite erosion in bullion prices, added 2.8%. It handily outperformed GDX, the gold-mining ETF, thanks to its large position in Red Back Mining, which Kinross wants to buy. **Agrium** the fertilizer manufacturer, was our second-best performer, up 14%. See page 2 for more on AGU. **Transocean** has snapped back, adding 10.2% (and 28.9% from its intra-month low) not only because oil no longer is spewing from the Macondo well but also because Wall Street finally is grasping that RIG apparently is insulated from nearly all of the tens of billions of dollars that will be paid in fines and compensation. Wall Street now thinks \$70 a share is right for RIG. We think that within a year, provided energy prices remain at current levels and our read on RIG's liability remains intact, that \$90 fits better.

As noted above, CGM Realty Fund surged and **Commonwealth REIT** (rebranded **HRPT Properties Trust**) added 4.4%. One reason for the disparity is that CGMRX has committed a significant portion of its portfolio not to traditional real estate but to mining stocks, a strategy that paid off handsomely the last time Ken Heebner, the fund manager, used it in 2007 and early 2008 but that then harmed performance when natural resource shares tumbled. We continue to think that Heebner over time gives shareholders the best chance for superior REIT results. This fund remains

Healthcare shares lagged the overall market as investors moved out of more defensive sectors to grab cyclical like the miners. Earnings season accentuated this trend. For instance, **Stryker**, best known for orthopedics, disappointed investors with less than expected results from its core business. Though older customers continued to sign up for new knees, hips and other replacement parts, younger customers did not. The driver seems to be that older patients can rely on Medicare to foot the costs, while younger customers either are not yet covered for such procedures or have no insurance at all. SYK tumbled 8.4%. Countering weakness in orthopedics, the MediSurge division, which sells



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
CommonWealth REIT***	CWH	NYSE	\$25.96	7.70%	\$28.00	BUY
Telecom New Zealand	NZT	NYSE	\$7.50	9.47%	\$8.00	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$66.29	0.33%	\$70.00	BUY
CarMax	KMX	NYSE	\$20.80	0.00%	\$26.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$23.49	2.63%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$32.42	1.34%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$95.92	1.14%	N/A	BUY
Fastenal	FAST	NASDAQ	\$51.16	1.56%	\$60.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$19.38	1.86%	N/A	BUY
Honeywell	HON	NYSE	\$43.77	2.77%	\$49.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$26.12	0.61%	\$31.00	BUY
Johnson & Johnson	JNJ	NYSE	\$59.96	3.60%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$21.61	0.00%	\$27.00	BUY
Mattel	MAT	NASDAQ	\$22.05	3.40%	\$26.50	BUY
Microsoft	MSFT	NASDAQ	\$25.55	2.04%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$45.68	2.10%	\$52.00	BUY
Pfizer	PFE	NYSE	\$16.24	4.43%	\$19.00	BUY
Stryker Corp.	SYK	NYSE	\$47.97	1.25%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$14.49	4.42%	\$18.00	BUY
Tetra Tech	TTEK	NASDAQ	\$20.75	0.00%	\$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$45.93	2.48%	N/A	BUY
United Parcel	UPS	NYSE	\$66.70	0.25%	\$70.00	BUY
UnitedHealth Group	UNH	NYSE	\$33.45	1.49%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$51.79	2.34%	\$60.00	BUY
Xerox	XRX	NYSE	\$9.59	1.79%	\$11.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$20.31	0.00%	\$24.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.19%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$36.43	4.61%	\$40.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$16.23	0.63%	\$19.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$38.04	0.03%	N/A	BUY
Aggressive Growth						
AOL Inc.	AOL	NYSE	\$22.44	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$5.80	0.00%	\$8.50	BUY
Comcast	CMCSA	NASDAQ	\$18.64	1.75%	\$21.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	0.00%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$47.21	7.28%	\$50.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$9.52	6.72%	\$10.26	BUY
Liberty Global	LBTYA	NASDAQ	\$29.49	0.00%	\$32.00	BUY
Maxim Integrated	MXIM	NASDAQ	\$17.75	4.51%	\$21.00	BUY
Symantec	SYMC	NASDAQ	\$13.04	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd****	TFCVX	800-443-1021	\$10.97	3.84%	N/A	BUY
Time Warner	TWX	NYSE	\$32.36	2.60%	\$34.00	BUY
Transocean	RIG	NYSE	\$57.11	0.00%	\$75.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$35.78	0.00%	N/A	BUY

* Prices as of Friday, August 6, 2010

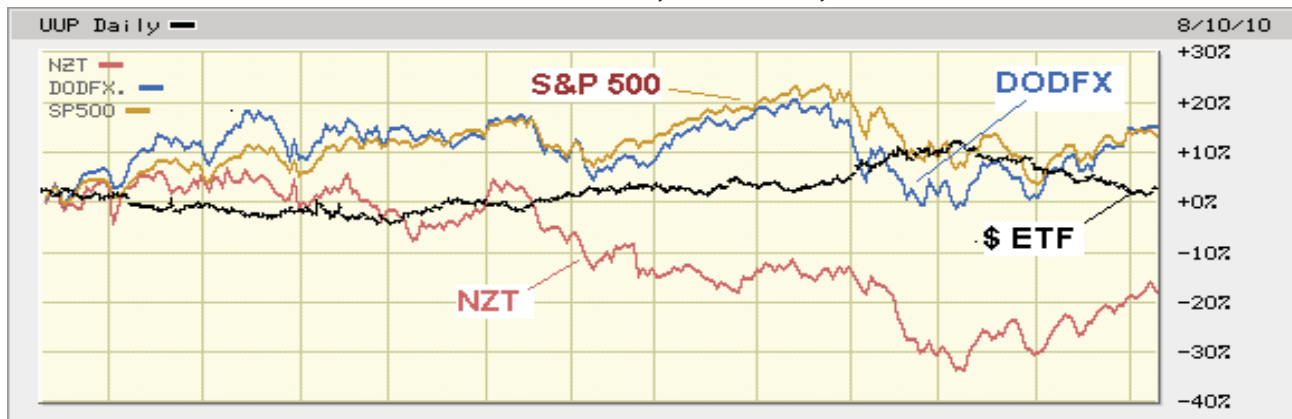
** Yield represents all income during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.

*** Name and Ticker changed from HRPT (HRP--NYSE)

**** Covers distributions from Aug 31, 2009 - June 30, 2010

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

US Dollar vs. NZT, DODFX, S&P 500



BigCharts.com

operating room and general hospital equipment, had very good results as hospitals have begun to play catch up for deferred capital equipment costs. We think that SYK is offering investors an opportunity at these prices.

Johnson & Johnson also has an orthopedics business and it too lagged, but JNJ's larger problem concerns recalls by its over-the-counter division that have tarnished JNJ's reputation. Since the last letter, JNJ is down 1%. JNJ also saw a slide in its stent business. **UnitedHealth Group**, the HMO, which came in with good results for the quarter, soared 11.6% as Wall Street suddenly is reconsidering the death sentence it had imposed on HMOs after healthcare reform was passed.

Given that Nasdaq added 4.2%, we would expect our own positions to have done well. **Microsoft** added 5.3%, but **Symantec**, after reporting weak results for the quarter that it blamed on corporate customer reticence to sign major contracts, fell 10.4%. If corporate hardware buying is picking up, we expect that SYMC's software and large data management businesses will improve. If not, we'll need to reconsider this stock. **Maxim Integrated**, the analog and mixed chip company, was flat. This was the second successive quarter in which MXIM reported that it could not keep up with demand from customers. Though this might sound good, it in fact is a threat to retaining customers. We're confident MXIM can overcome this. With a bullet-proof balance sheet and near 5% yield, we're happy to wait for better results in coming quarters. **Xerox** turned out to be the portfolio's best performer, up 16.7% after announcing superior numbers that result primarily from its acquisition of ACS earlier this year.

Automotive shares did very well. See page 2 for our **Ford Convertible Preferred** that added 13.8%. Remember that in the future F-PS will be paying its dividend after resuming payments last month. **Superior Industries**, which designs and manufactures wheel coverings and other parts for auto manufacturers,

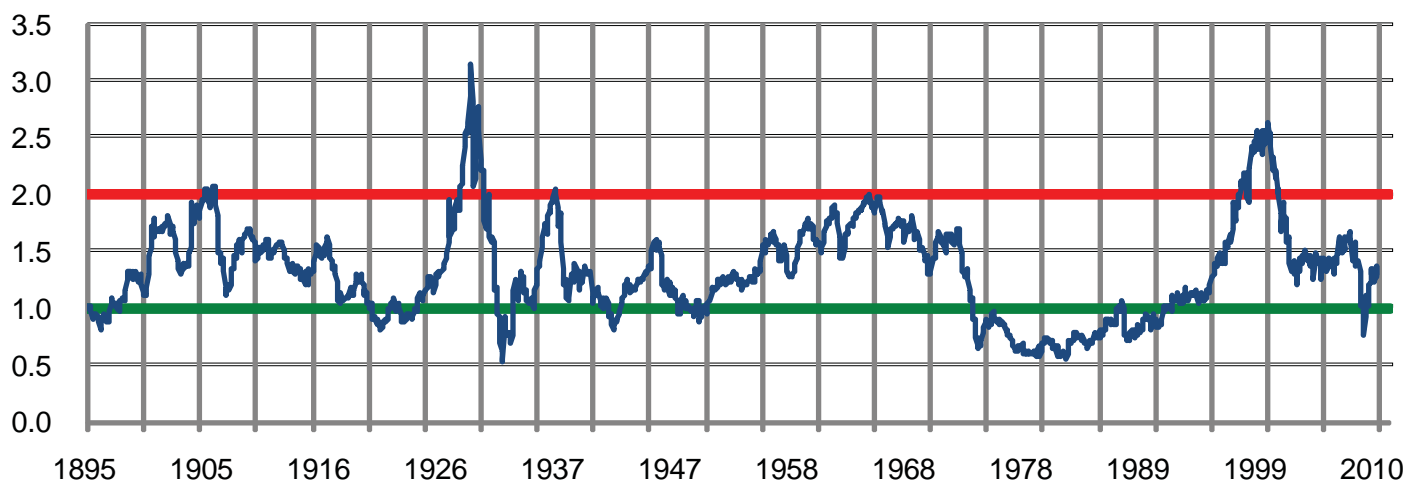
added 10.2%, though earnings won't be announced till we've gone to press. What makes SUP interesting, aside from its debt-free balance sheet and 4.4% yield, is how tied it is to an economic recovery, especially among consumers. With consumer confidence on the rocks, any positive news from that sector would boost the shares dramatically.

CarMax, which is tightly tied to consumer spending, added 7.5%, had filed its earnings numbers early in the season (last week of June), which suggests that shares moved higher as investors got more comfortable with avoiding renewed recession.

International Speedway, has suffered along with its primarily young, blue-collar fans as the economy slipped, cut costs for the second quarter but still is contending with reduced revenues and write-downs of its investment in Motorsports Authentics, which produces and markets die-cast car models to NASCAR fans. Though ISCA is still filling the stands, the crucial sale of souvenirs, food and drink will remain impaired until consumers are confident they can spare to spend. Since the last letter, ISCA is up 1.2%.

Media shares enjoyed a nice run. For **AOL** see page 1. **Time Warner**, now demerged from AOL, did even better, up 7.2%. **Liberty Global**, which has been strong all year, added 6.3% despite lower-than-expected profits but higher revenues. **Comcast** increased 3.7%.

Finally, **Telecom New Zealand**, on the strength of a stronger NZ dollar, added 9.7%. The U.S. dollar has given back a hunk of the gains it enjoyed earlier this year. Look at the chart that tracks the Greenback against the S&P 500 as well as both NZT and the **Dodge & Cox International Stock Fund** (+7.6%). For American companies, a weaker dollar boosts exports and discourages imports, while it enhances the dollar value of foreign assets. **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 1.31. 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

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.

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		

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 33 percent. See Page 2 for some context.