



It's a staple of economic commentary that the American consumer accounts for 70% of our country's economic activity, at least historically that's been the case. But because the single largest asset for American consumers is their homes, the impact of the real estate market's steep decline that began in 2006 and turned into a total collapse in 2007-2008 has been extraordinarily painful for consumer confidence, consumer spending and coincided with a severe bear market for stocks.

It's not that there is a cause-and-effect relationship between the two asset classes. Instead, thanks to the Federal Reserve's very accommodative interest rate policies earlier in the decade in resisting a mild recession and the aftermath of 9/11, both the housing market and the stock market enjoyed exceptional returns. Add in reckless lending that accelerated housing's run and you understand why home prices exploded.

Once again, the Fed has dropped interest rates even further to combat the Great Recession, hoping to revive housing and stocks, but while stock prices have recouped almost all of their losses since they imploded, housing prices remain moribund. The artificial stimulation that cheap money has had on stock prices can only last so long unless the housing market returns to health. Mortgage defaults and foreclosures remain stubbornly high.

Starting with this issue, *Sound Advice* will present statistics on this most critical aspect of the housing market. You can read starting on page 8 how crucial we think this economic force will be in determining whether equities can build upon the expectations that stock prices suggest. We will know when it is a good time to invest in real estate for pennies on the dollar or in REITs and REIT funds as well as other beneficiaries of a rebounding economy's housing sector.

-Gray Emerson Cardiff

Consensus and Uncertainty

By now *Sound Advice* readers know that we love when investors' mood during the bear market and the recovery in equities ranged from downright hostile to wary, which provided opportunities to buy cheaply. It does make us feel lonely but it also makes us more confident about equities in general. A recent [Reuters report](#) chronicles how disenchanted the public has become about stocks. Investors over the last decade have suffered two major bear retreats. There is a general sense that the game is rigged. Front running by favored mutual fund clients, the flawed (fraudulent?) way Wall Street churned out securitized mortgages and how rating agencies blessed them, the flash crash and recurrent headlines about insider trading make it all too easy to stay away.

How many times have we heard from Lookie-Lou's, who after seeing our performance in places like the *Hulbert Financial Digest* show interest in subscribing, but say they still are sitting on the sidelines, waiting for the market to "stabilize," waiting for "clarity," waiting for the cross currents to resolve before getting into equities. One fellow explained his aversion by lecturing us on why "the market hates uncertainty." We laughed, suggesting that there was certainty in the market, but it was negative certainty. We recommended he read Barry Ritholtz's remarks on the Bloomberg site, which strip away the foolishness inherent in that mindset: "Pundits," Ritholtz observes, "may hate uncertainty -- it tends to make them look foolish -- but markets harbor no such bias. In fact, markets thrive on uncertainty. It is their reason for being." The opposite, buoyant consensus, is what the market should hate. Yes, in 1999 and early 2000 there was consensus that we had entered a New Era: the boom and bust of the business cycle had been banished, at least according to this dogma. You could buy anything (but especially tech) and make money. How could such certainty seemingly overnight vanish as it did in March 2000? The next time it was real estate from 2002-2006. It was wonderful while the music lasted.

Real opportunities come when the market is either at its most uncertain or most confident. Thus, in September 1999 we asked "What's With Real Estate?" We should have said "What's With Investors?" Commercial real estate was appreciating smartly but REITs, chock full of these assets, were stagnant or dropping in price as Wall Street instead chased tech dreams. Yields on REITs were averaging 8.5%! At the time our portfolio had nine REIT investments, and as the overall market in 2000 faltered, REITs soared. When the market itself began to rally in 2003, REITs did even better. As the REIT rally boomed and investors pushed them beyond the value of their properties, we started peeling them off. We had a similar experience with commodities, which we saw as neglected back in late 2002. For example, Phelps Dodge rewarded us with a 643% profit, while [Agrium](#), which is still in our portfolio, has returned 745%. Now we think natural gas makes sense.



Buying Into Oversupply

In September 2009, when *Sound Advice* needed to find a new energy fund, rather than selecting a general fund we recommended **Fidelity Select Natural Gas Fund**. Our rationale was simple: “when oil bottomed in the high \$30s at the start of this year and as it then nearly doubled, natural gas didn’t get the message. Indeed, the spot price for Henry Hub (Louisiana) Natural Gas today stands at \$1.84 per million British Thermal Units (mBtu), a seven-year low. The *New York Times* headlined last week “No Floor In Sight for Natural Gas.” We must admit, we like headlines like that, since they usually emerge at price extremes.”

In retrospect, we were right about \$1.84 per mBTU being an extremely low price. However, as oil seems to have found a range between \$80 and \$90 a barrel, spot prices for natural gas, after recovering, have retreated. Almost every obstacle to natural gas catching up to oil we discounted in 2009 remains just as—perhaps even more—relevant today, which prompts us to return to this natural resource pariah to poke around for values. In fact, there are many natural gas exploration and development companies that we could recommend at this point because the dynamics in the natural gas sector have depressed the prices of almost all players, but **EnCana (ECA—NYSE)** has several advantages.

Relative to its peers, ECA is a bargain: Price/Earnings ratio of 10 is barely half of its peers’. Price/Book at 1.2 also is roughly half. Price/Sales at 2.1% is 2/3rds of the industry average while Price/Cash Flow is even at around 7 times. Dividend yield is 2.8% while the industry average is 1.7%.

EnCana

At the end of the 1990s, natural gas exploration and development companies were ascendant. Devon, for instance, had more than sextupled over the decade. After a dip during the 2001-2002 recession, natural gas exploration and development companies resumed their climb until they again fell off a cliff in mid-2008. Devon has seen its shares fall by 38%. Unlike natural gas exploration and development companies’ fall and subsequent recovery earlier in the decade, this time the problem is not simply a recession but a revolution in drilling technology that has turned the natural gas industry upside down.

Sound Advice subscribers might be familiar with EnCana, because in February 2002 we recommended Alberta Energy, which soon merged with PanCanadian Energy to become EnCana. At the time, energy prices were trending downward after a strong run in 2001. After peaking in 2001 at \$10 per mBTU (versus \$35 a barrel for West Texas Crude), by the time we introduced Alberta Energy, natural gas had collapsed to \$2.16 per mBTU and West Texas Crude to \$19.48. That recommendation resulted in a 143% return.

Toward the end of last year, the old EnCana completed a long-planned separation of the oil and natural gas

businesses. The new EnCana retained the natural gas properties and Cenovus (CVE—NYSE), which was spun off to old EnCana shareholders, took the oil properties. Management felt, correctly as it has turned out, that the market was undervaluing its oil component and the company needed to change that perception.

For the year since the division, the respective share prices validate that decision: EnCana is barely higher (+5.3%) on a total return basis, while Cenovus has increased 35.2%. Natural gas exploration and development companies over this same period have been a mixed bag: some, like Newfield and Cimarex, which are bite-sized companies with market caps in the single-digits that are considered likely acquisition candidates, have soared (+82% and +86% respectively)

while others like EnCana and Devon, the two largest natural gas exploration and development companies, which are unlikely buyout candidates, have done next to nothing. Given the drop in natural gas prices over that period, doing next to nothing is better than falling in tandem with the underlying commodity. Natural gas is about 20% lower than when the year began.

To understand why natural gas and companies that look for and develop natural gas have stagnated while oil and oil companies this year have surged, we need to

look at a literal revolution in how energy companies access natural gas today.

Peak Natural Gas?

M. King Hubbert, a Royal Dutch Shell geologist, hypothesized that between 1960 and 1970 U.S. oil production would begin to decline as oil reserves were depleted. Ridiculed, Hubbert’s “peak oil” predictions were validated in 1970. Less known is Hubbert’s projection for “peak natural gas,” which he first said would occur in about 1970, and then pushed forward to 1975 and then 1980. As recently as 2005, Lee Raymond, then CEO at Exxon, announced “Gas production has peaked in North America.”[In 2005, dry (that is natural gas not in liquid form) natural gas production in the United States amounted to 18.05 trillion cubic feet, while total production (dry plus natural gas pulled from oil wells) totaled 23.46 trillion cubic feet. In 2009, four years after Raymond’s prediction, which in retrospect rivals the “Dewey Beats Truman” headlines, dry production hit 20.96 trillion cubic feet and total production 26.18 trillion. Rather than talking about “peak natural gas,” bears are sniggering about “peak natural gas storage,” that is, should production continue to rise and demand not outstrip that production, the industry might find itself with nowhere to store the stuff. Gas in storage peaked last month at 3843 trillion cubic feet, the highest level since the U.S. Department of Energy began compiling statistics

in December 1993. Stored gas has now begun a seasonal decline as cold weather heating needs draw down supplies. However, come late March, storage numbers again will begin to climb. Unless demand increases or production is curtailed, we can expect even higher storage figures next November. What happened?

A Technological Revolution

The simple answer is industry's ability literally to produce natural gas, if not out of thin air, then out of stone, or to be more precise from shale. Geologists have long known that immense amounts of natural gas, liquefied natural gas and oil were trapped in shale deposits, but it was technically difficult and very expensive to release these hydrocarbons. However, as oil and natural gas in 2008 hurtled to unthinkable levels (oil reached \$147 and natural gas \$13.31 per mBTU after Katrina and Rita hit the Gulf of Mexico's drilling rigs), what had been considered too expensive to pursue suddenly became feasible. At the same time, industry analysis revealed vast potential for northern Louisiana's Haynesville Shale. When those high water prices for oil and natural gas collapsed under the weight of the financial crisis, a deep recession and what in retrospect were their own clearly overheated prices, the higher recovery costs for shale gas briefly muted enthusiasm about it. But that has changed as new techniques have cut recovery costs and now shale gas has flooded the market. Though oil has rebounded if not to the inflated prices of July 2008 at least to a respectable \$88 a barrel. Natural gas has decoupled from oil and has stagnated. Natural gas after rallying as far as \$5.14 this past January has dropped back to \$4.43.

Fracturing or "fracking" the shale by injecting into it chemicals mixed with water under high pressure creates channels for the trapped gas and other hydrocarbons to be pushed toward the surface by subterranean pressure. Energy companies are finding new fields at a rapid clip and leasing acreage as fast as they can. The first region to be tapped during the new era of shale gas was in Texas around Fort Worth (Barnett), then Fayetteville in Northern Arkansas, then nearby in Woodford, Oklahoma, then Haynesville which straddles the Texas-Louisiana border, then Marcellus that runs from West Virginia to Pennsylvania and New York and most recently Eagle Ford which is south and east of San Antonio. There are at least another six regions elsewhere in the U.S. and Canada that are being explored. Leasing rates have gone as high as \$20,000 an acre with the potential should the wells be productive of 25% royalties, which have created real-life Beverly Hillbillies in some hard scrabble communities. And this is only in North America. Everywhere from Poland to Argentina to China to India, development of shale hydrocarbons is happening.

This rush is fueled in part by energy companies, including the super-majors like Exxon Mobil and Chevron, feeling pushed to get onto this explosive new frontier, and in part by exploration and development companies like Chesapeake, Devon and EOG taking on joint venture partners, many of

them foreign, to finance leases.

In such joint ventures there is an obligation to not just drill but to start production almost regardless of whether market prices justify production. Energy companies when they lease acreage also are obligated to drill before their leases expire. Combine these pressures with the availability of these new fields and you can appreciate why natural gas prices have declined this year, and why most natural gas companies, especially larger ones like EnCana have stagnated as well. Of the three largest, only Devon, the king at a market cap of \$31.7 billion has had a good year, up 16%, while EOG, which at \$23 billion, which is 10% larger than ECA is up 6.8%, not much better than ECA's 6.3% performance.

But Someone's Making Money

Just as energy companies are piling into rural communities to lease acreage, the biggest companies are snapping up small and mid-sized competitors that have accumulated acreage in the richest shale plays. Chevron, for instance recently announced it would acquire Atlas Energy for \$3.2 billion, a 37% premium over where the shares had traded before the deal was announced. Exxon Mobil earlier this year completed its blockbuster \$41 billion acquisition of XTO Energy, doubling its natural gas reserves and increasing its overall energy reserves by 10%. Exxon paid a 25% premium for XTO shares. StatoilHydro, the Norwegian energy company, has forged a partnership with Chesapeake Energy and Williams company paid almost \$11,000 an acre for natural gas reserves in the Bakken (North Dakota) shale region. China's CNOOC, India's Reliance, France's Total and England's BP are all partnering in shale projects with North American natural gas development companies.

The entry of super-majors into the shale natural gas business introduces a longer-term perspective that contrasts with the drill-baby-drill mentality of exploration and development companies, particularly the smaller players. EnCana, with its \$21 billion market cap and robust balance sheet, can act more like the super-majors than its smaller rivals. By slowing development and even closing down production temporarily, energy companies could help support natural gas prices.

Even more helpful would be increasing demand for natural gas. The attractiveness of natural gas as an energy source is incontrovertible. When used to generate electricity, natural gas emits less than half the carbon coal does. Today just over 30% of America's electricity is generated from coal. The EPA estimates that of the 372 power plants to be built over the next three years 206 will use natural gas.

On the other end of the energy spectrum, renewable energy from wind or sun, natural gas also enjoys an advantage: it costs 53% less than does wind power and 21% less than electricity from photovoltaics—at least at current natural gas prices versus the infrastructure and transmission costs for alternatives. And then there are new uses for natural gas.

Boone Pickens, the energy entrepreneur, has poured big money into natural gas, and has been promoting the idea that were the United States to replace its diesel-fueled trucks with trucks fueled with natural gas, the country could reduce oil imports by a third and at the same time improve air quality to say nothing of untethering the U.S. economy from foreign suppliers, many of whom are unfriendly to America. It remains an uphill fight, especially while U.S. corporations are unsure about capital expenditures. Still, some companies see long-term value in using natural gas. AT&T, for instance, intends to have 20% of its fleet running on natural gas, and several cities such as New York, Atlanta and Los Angeles have converted a portion of their busses to run on natural gas.

Another support for prices might occur should fracking become more closely regulated for environmental reasons, which already have triggered a moratorium on projects in New York State. Frankly, no one is certain what long-term collateral damage occurs when a mix of water and chemicals under high pressure is injected thousands of feet under the earth. Furthermore, a typical fracking requires one million gallons of water, which in some areas might strain local supplies. It's unlikely that fracking would be prohibited, but any change in what now is a wide-open industry would raise natural gas prices. Finally, there is the simple fact that as the economy recovers, demand will rise for all energy sources.

Advantages

EnCana enjoys a superior long-term advantage against its peers thanks to its size, the strength of its balance sheet and its history of technological innovation. For example, EnCana hasn't burdened its balance sheet when acquiring shale acreage. Instead, when in 2008 it made a large commitment (\$1.9 billion) to shale properties, it financed its new acreage by selling off conventional resources elsewhere. Indeed, well before splitting the gas and oil portions of the company, management had disposed of most of its international holdings. ECA is sharply focused in North America. ECA is essentially a North American play on natural gas.

Because finances are strong EnCana can afford to slow down development during a period of price weakness. As Randy Eresman, EnCana's CEO, stated in the Q3 conference call back in October: "we will not chase production growth at any cost," citing inflated prices for drilling services in the Haynesville region as to why ECA had reduced exploitation of this area. Nonetheless, EnCana's goal is to double production in five years.

However, that presumes the price of natural gas will rise from what Eresman considers unsustainable levels in today's market. He considers \$6 per mBTU to be where the market needs to go. If ECA does reduce drilling activity and along with it capital expenditures, cash flow that those activities would have absorbed could be used to buy back shares at what management considers depressed levels. We expect EnCana in the new year to boost its share buy back, which is good news for long-term investors.

On the plus side, EnCana's acquisition and development costs are among the lowest in the industry, which means that it is in a better position to weather this period of cheap prices. EnCana, though it might be relatively new to the shale business, has a history of innovation in oil sands in Canada, which demands comparable expertise. For example, management is introducing a new technique, "the gas factory" that moves individual wells closer together that allows equipment to be shared that reduces costs considerably.

In its Q3 conference call in October, EnCana said in response to rising operation costs that it would reduce by 10% the number of new wells and cut back on production at existing wells. The cost pressures are coming primarily in the shale gas regions of the United States, where rigs are in short supply. But even after selling off a large hunk of its Canadian conventional natural gas properties, EnCana still owns conventional acreage there and in the U.S, which lately has proved less expensive to exploit. Development costs in Canada for conventional natural gas projects fell 7% over the last 12 months.

Valuations

Customarily *Sound Advice* compares a company's current price ratios to their historical averages. EnCana, barely a year as a stand-alone, does not have enough history. Instead, we can look at how its valuations compare with competitors. In that context, ECA's Price/Earnings ratio of 10 is barely half of its peers'. Price/Book at 1.2 also is roughly half. Price/Sales at 2.1% is 2/3rds of the industry average while Price/Cash Flow is even at around 7 times. Dividend yield is 2.8% while the industry average is 1.7%.

In short, EnCana relative to its competitors is a bargain, which has several reasons: smaller natural gas companies at the moment are seen as takeover candidates, thus boosting their ratios at the expense of the biggest companies. There's also the likelihood that once holders of old EnCana shares could split the company's oil and natural gas components, they shed the natural gas. It's hardly surprising that buyers have not flocked to the depressed natural gas industry, which, we believe, offers us an opportunity, provided you don't accept the argument that natural gas will remain in permanent oversupply. Lee Raymond got supply wrong five years ago. Why should we be so certain industry experts are any better at projecting the future? We freely admit that it's a confusing time to be considering natural gas. However, markets eventually are self correcting. Despite the contractual need for some developers to sink wells and produce gas, today's prices are forcing others to close-in wells. We expect this trend will pick up speed.

A more likely support for gas prices will involve increased demand. We already are seeing end users turning to natural gas and we expect, provided oil moves higher or even holds its current range of \$80-90, that end users will migrate away from oil and coal toward natural gas. When demand for natural gas better matches supply, whether demand surges or supply is constrained, EnCana will be superbly situated to prosper. We recommend ECA up to \$34.

Portfolio Updates

Each November *Sound Advice* selects a quintet of existing positions we believe have a good chance of outperforming the overall market for the next 12 months. Historically, though not every year, they've performed as hoped, which reflects more the tendency of downtrodden sectors and stocks (which these almost invariably are) to recover than it does any particular brilliance on our part. Our primary contribution is a willingness to do what does not come easily or naturally for most investors: put money into positions that have not made money.

Since we priced the portfolio on November 5th, the Dow is down 0.3%, the S&P is up 1.2%, the Nasdaq 2.3% and the pan-market Wilshire 5000 1.8%. The *Sound Advice* portfolio as a whole has advanced 1.9%. The economic back and forth for this advance included a resurgent dollar as Europe again contends with sovereign debt, government austerity programs and the social upheaval such policies trigger. China again is trying to cool its economy by restricting lending. Resolution of the Washington debate over tax rates might add to confidence among investors.

Against this backdrop, the Five for 2011 basket is up 7.6%. **Tetra Tech**, the water remediation company, is up 16.5% after announcing it beat expectations for Q1 and more significantly signaled that the coming quarter and the balance of the year should also exceed expectations. **Transocean**, the ultra deepwater driller still mired in the Deepwater Horizon catastrophe that took the lives of 11 workers and caused yet uncalculated environmental and ecological damage in the Gulf of Mexico, also is up 13% as the threat of legal and financial responsibility for the damage retreats. Oil is back comfortably above \$80 again, well beyond the price level Transocean considers sufficient for creating profitable contracts. Our wait for Swiss regulators to allow RIG to make the dividend payment that had been blocked in the wake of the Deepwater Horizon disaster is on hold. A Swiss court earlier this month blocked RIG once more from making the distribution.

Boston Scientific has been moving higher lately, up another 2.8%. At an analysts' conference before Thanksgiving, Boston Scientific was upbeat about improving profits. One positive step announced just before the meeting was acquisition of a small California company that has developed a heart valve that can be introduced with a catheter rather than requiring major chest surgery. Other firms such as Edwards Life Sciences already are selling such devices, but Boston Scientific believes its new technology is superior. As with everything else in this recovering company, we'll see.

Leucadia is up 4.2%. LUK has sold its remaining 30% interest in its Spanish copper mine (Cobre las Cruces) to its partner, Inmet, a Canadian metals miner, for \$150 million

in cash, approximately 5.4 million shares of Inmet as well as forgiveness of Leucadia's guarantee on a \$72 million loan from Inmet to the mining company. LUK now owns over 11 million shares or 17.9% of Inmet. LUK announced last week that it would pay a 25 cent dividend for 2010, the first time the company has done that since 2007. The last position, **Dodge & Cox Stock Fund**, is up 1.5%. It's just the first month for the class of 2011, so don't just multiply the quintet's returns by 12 and declare victory. Mind you, we're not complaining either.

We're getting the sense that Americans are feeling better about the economy. Yes, unemployment remains intolerable (up to 9.8%), but consumer confidence is coming in better and holiday spending appears to be strong. Companies also are showing a willingness if not to start spending more, they at least are increasing their dividends. Thus **Honeywell**, which quietly has been having a good year (+35.7%) announced it would increase its dividend by 12 cents to \$1.33. **Fastenal**, which prospers when its industrial customers order more screws, bolts and hardware, even with the construction industry in the doldrums, sweetened its distributions by declaring a special 42 cent dividend to shareholders of record as of November 24th. Since the last letter, FAST is up 10.9%.

The sense that the U.S. economy is beginning to uncoil carried over to all our cyclical positions. UPS, just as the holiday shipping frenzy picks up, is up 4.4%. **Powershares Water Resources Fund**, which holds a large position in Tetra Tech but is more of an industrial products company, posted a 5.4% rise. **Paychex**, the October recommendation, a payroll services provider, is yoked to the economy's ability to create jobs. It's up 7.6% since the November issue and 11.3% since entering the portfolio at the start of October. Frankly, for conservative investors looking for a better-than-average yield (4.3% at today's close), a bullet-proof balance sheet (zero long-term debt), excellent management and a situation keyed to economic recovery, there are few better stocks out there—at least we think.

Superior Industries, the supplier of wheels and rims to the (not so big anymore) three automakers, jumped 12.9%. In fact, all things auto are working nicely. **CarMax**, which sells used cars, added 6.7% and our **Ford Convertible Preferred** moved 1.3% higher. Now that this issue is above par (\$50) some are speculating that Ford will redeem the series. We're not worried, at least for the moment. Until the Ford common shares into which this security can be converted (2.8249 shares of F for every preferred share) move significantly above \$17.70, there will be no incentive for Ford to call the issue. Even **International Speedway**, which owns and operates a string of auto racing venues and thus qualifies barely as an auto stock, increased 9.1%. However, investor interest in ISCA marches not to the

beat of improving auto sales but to improving consumer confidence, which is up.

Mattel on November 15th, a very bad day for the overall market (S&P was down 1.6%), announced three pieces of news: first, it was going to make its dividends payable quarterly rather than the current annual event; second, it was going to increase its dividend from 75 to 83 cents and third it was boosting its share buyback program by \$500 million. However, what probably caused MAT to jump 3.1% on the day was word that Carl Icahn's investing company had taken a 1.1% position in Mattel shares. Some see Mattel's abrupt shareholder friendly news as a preemptive strike against Icahn's likely criticism. Then, just as we are pricing the portfolio, this weekend's *Barron's* cover story projected even higher share prices, noting that Icahn probably has no plans for Mattel beyond seeing it as "a well managed company with a world-class brand and an undervalued stock." We agree. MAT is up 9.9% since the last letter and 23.4% year to date.

Healthcare not surprisingly with less defensive sectors rallying stepped back. With the exception of BSX, shares of **UnitedHealth Group**, the HMO and **Pfizer** fell less than 1%. There was news from Pfizer, whose CEO abruptly retired and is being replaced by an insider. **Johnson & Johnson**, however, continues to stumble, dropping 4.2% after yet another of its non-prescription divisions had to recall some products for trivial reasons. Over the last few months, JNJ has stumbled repeatedly and revealed holes in its reputation. We're counting on its recovery and with a 3.5% yield is attractive. **Stryker** added 1.1% and **Hambrecht & Quist Life Sciences Fund** increased 1.7% after its quarterly distribution.

Technology shares were a mixed bag. One standout is **Maxim Integrated**, which added another 9.5%. The chip maker has been extraordinarily strong over the last 10 weeks, even in comparison to its peer group. **Microsoft** edged up 1.3%, **Xerox** 0.8% and **Symantec** was flat, while the **Seligman Premium Technology Fund** increased 1.3% thanks to its distribution.

Commonwealth REIT, the old HRPT Properties Trust, shuffled off \$670 million in medical properties to Senior Housing Properties, which itself had been spun off from HRPT more than a decade ago. The deal further focuses CWH on office and light industrial properties and provides a cash hoard to reduce debt and finance acquisitions. Since CWH floated a secondary offering of its common shares, its price has remained under \$26 and today closed at \$24.94. We're content to collect the dividend, reinvest it and wait for better days. Our other REIT position, **CGM Real Estate Fund**, is down 1.9%. REITs like financial services stocks are having trouble coping with rising interest rates. The **Davis Financial Fund** slipped 2.5% for this reason.

The resurgent dollar has harmed natural resource shares. **Anglo American**, the mining holding company, is off 1.5% and **Plum Creek Timber**, after going ex-dividend, is off

4.5%. **Agrium**, the Canadian fertilizer company, now that the game playing surrounding BHP Billiton's hostile offer to acquire Potash Company has died, gave back 3.9%. With the dollar seen as a haven, that other safe harbor, gold, has not done as well, losing price since peaking earlier in November. **USAA Precious Metals & Minerals Fund** took the dollar rise hard, down 7.5%. **Fidelity Select Natural Gas Fund** is up 2.1%, good but not close to what is happening to oil-related shares. See the recommendation for **EnCana** starting on page 2 for more on natural gas.

Foreign shares also suffered as the dollar rose. **Liberty Global Media**, which is building national cable networks, dropped 6.7%, the first time this year it has cooled off. It's been a very profitable investment (LBTYA is up 68.1% for the year), but at this point we are willing to cut it loose and are selling it out of the portfolio. We still have **Comcast** in the portfolio for exposure to cable. CMCSA was up 1.3%.

Dodge & Cox International Fund is 2% lower. **Third Avenue Value Fund**, though technically not an international fund, with its heavy exposure to Asian holding companies, got a double whammy but held up well, dropping less than half a percent. **Telecom New Zealand** dropped 5% as investors took the quarterly distribution and then sold. NZT's cash flow is down and will remain so for the coming year, which means that the distribution, as this quarter showed, will be cut. We still like NZT both for the remaining distribution and its potential for recovery.

With the dollar bobbing higher while the Euro was tumbling and with the Federal Reserve buying longer duration Treasuries, you'd expect Treasuries to be shooting higher. But that's not the case. Rates currently are well above levels hit in the lead-up to Quantitative Easing. Perhaps a sense that the U.S. economy is moving forward and out of recession has trumped the effect of QE2. It seems that the market went off the deep end in bidding bonds higher after the Fed announced its intentions and is now paying the price. This month the **ProShares UltraShort 20+ Years Treasuries ETF** is up another 8.5% after last month's 11.9% jump. We're not about to predict where the Treasury market is heading next week or next month. But we'd be surprised 12 months from now were rates not higher than they are today. Provided rates rise in response to an improving economy, the market should respond positively, though professional investors have gotten so accustomed to rock bottom interest rates that they initially might run for cover regardless of why rates are rising.

For a year that was supposed to be dangerous for equities and during which the average investor has hid in bonds and bond funds, 2010 has shaped up nicely. Looking backward, it's easy to forget how anxious market pundits got during the spring swoon, or how they predicted a terrible September and an even worse October, which turned out to be extraordinarily robust. Now in the upper double digits on a total return basis, our performance is ahead of all broad market measures. So far, so good.

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
CommonWealth REIT***	CWH	NYSE	\$24.94	8.02%	\$28.00	BUY
Telecom New Zealand	NZT	NYSE	\$7.81	9.82%	\$8.70	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$81.87	0.27%	\$90.00	BUY
CarMax	KMX	NYSE	\$34.52	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$25.90	2.39%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$21.31	1.53%	\$25.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$35.53	1.23%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$106.51	1.03%	N/A	BUY
Fastenal	FAST	NASDAQ	\$59.17	2.13%	\$65.00	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$52.00	7.28%	\$55.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$20.54	1.75%	N/A	BUY
Honeywell	HON	NYSE	\$51.98	2.33%	\$56.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$25.63	0.62%	\$28.00	BUY
Johnson & Johnson	JNJ	NYSE	\$61.91	3.49%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$28.44	0.00%	\$34.00	BUY
Mattel	MAT	NASDAQ	\$25.48	2.94%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$27.34	1.90%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$49.30	1.95%	\$54.00	BUY
Paychex	PAYX	NASDAQ	\$30.35	4.09%	\$35.00	BUY
Pfizer	PFE	NYSE	\$17.02	4.23%	\$19.00	BUY
Stryker Corp.	SYK	NYSE	\$53.00	1.13%	\$55.00	BUY
Superior Industries	SUP	NYSE	\$20.72	3.09%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$25.26	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$51.07	2.23%	N/A	BUY
Time Warner	TWX	NYSE	\$31.79	2.64%	\$34.00	BUY
United Parcel	UPS	NYSE	\$72.89	2.58%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$36.67	1.36%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$54.28	2.23%	\$60.00	BUY
Xerox	XRX	NYSE	\$12.00	1.43%	\$14.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$24.12	0.00%	\$28.00	BUY
EnCana	ECA	NYSE/TSE	\$28.73	2.78%	\$34.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.17%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$36.73	4.57%	\$42.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$19.09	0.54%	\$19.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$42.87	0.02%	N/A	BUY
Aggressive Growth						
AOL Inc.	AOL	NYSE	\$25.33	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$7.11	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$10.19	6.97%	\$11.89	BUY
Liberty Global	LBTYA	NASDAQ	\$36.79	0.00%	N/A	SELL
Maxim Integrated	MXIM	NASDAQ	\$24.61	3.41%	\$25.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$19.21	9.64%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$17.20	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd****	TFCVX	800-443-1021	\$11.42	5.28%	N/A	BUY
Transocean	RIG	NYSE	\$73.23	0.00%	\$80.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$38.28	0.00%	N/A	BUY

* Prices as of Friday, December 10, 2010

** Yield represents all distributions 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 - October 1, 2010

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

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

The rising tide of home foreclosures began in 2007 as a symptom of faltering real estate markets across the country. But as the rising tide turned into a tidal wave, falling real estate prices have compromised the assets of the US banking system and the fabric of the US and worldwide economies. Indeed, the state of the nation's real estate markets and the economy have become one and the same. Clearly, the recession cannot be fully put behind us and a recovery kick into full gear until the inventory of foreclosed homes stops overhanging the market.

We have seen all this before. It was back in the 1980s. After years of loose and questionable lending practices, regulators were forced to liquidate hundreds of savings and loans and dump their foreclosed real estate onto an already-depressed real estate market. As values dropped, the downward spiral continued until most of the real estate was sold at steep discounts. The crash was worse in some parts of the country, but the damage to the whole US economy was substantial. Does this sound familiar?

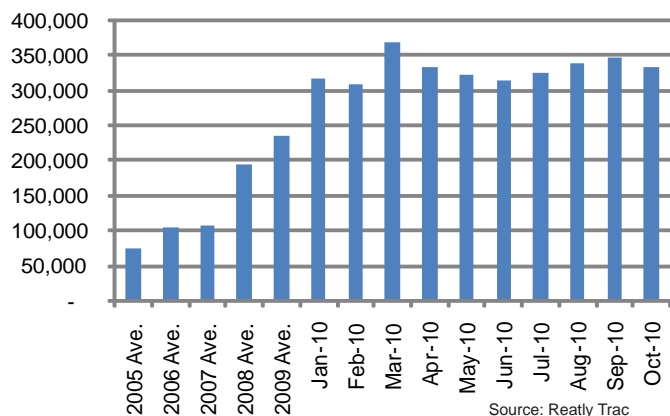
We have the same situation today. It's like the old good news/bad news jokes, except this is no laughing matter. The bad news is that today's crash has been damaging, to both real estate prices and the national economy.

The good news is that we have the tools to determine when the bad news will be over. This will give us a tremendous opportunity to not only invest in real estate for pennies on the dollar at the right time, but also in other investments as well that benefit from a recovering economy.

The Key Indicator

The secret is to focus on foreclosure rates. Fortunately, Realty Trac in Irvine California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We present some of their data here to gauge the state of the nation and its real estate, and plan to continue to do so in future issues of SoundAdvice.

US Foreclosure Rates
Monthly Averages



Take a look at the chart above on US foreclosure rates.

In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above

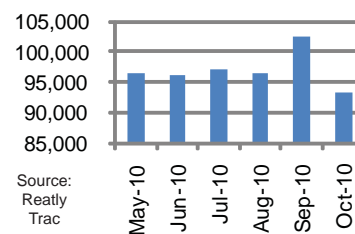
100,000 per month. However, by the time January 2010 rolled around, foreclosures climbed to over 300,000 per month, and foreclosures continued to persist over 300,000 each month through October – the latest data available.

What we are looking for is a significant drop in the number of foreclosures over several months. When this happens, the bulk of the overhanging inventory of foreclosed properties will have been digested, and the recovery can then begin in real estate as well as the economy. In the late 1980s, this was the best indicator for knowing when the recovery was near. As foreclosure rates dropped, the ensuing recovery began. For nearly two decades, fortunes were made from real estate purchased for pennies on the dollar during the S&L Crises of the 1980s.

As we can see from the chart, there currently is no sign of a meaningful decline in foreclosure rates. There was a slight dip in foreclosures during October 2010, however that can be attributed to the freeze in foreclosures by Bank of America on October 8th which continued through much of the month on 102,000 foreclosure actions. JP Morgan Chase also had a freeze on 56,000 actions. The GMAC unit of Ally Financial also had a freeze during the month.

While foreclosure rates are a leading indicator, we believe that some of the data that goes into compiling the foreclosure rates has even better predictive value. This is because the number of foreclosures is measured by adding up the properties in each of the three stages of the foreclosure process: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. Because the first stage, new default filings, is the first step in the foreclosure process, it should therefore be an early indicator of a change in trends. The chart shows new US default filings by month for the last six months.

New Default Notices



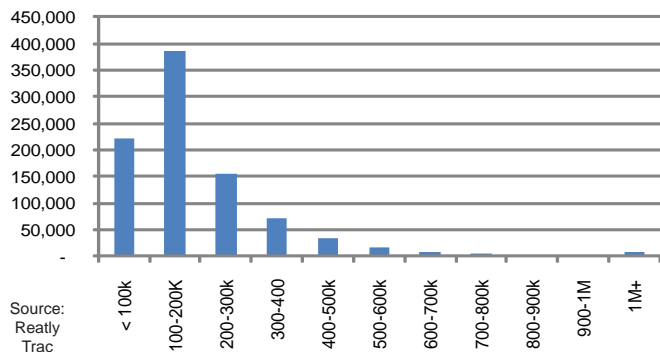
So far, we see no signs of a downward trend in new default filings. October shows a slight decline which is likely due to the foreclosure freeze.

The Size of the Problem

It is interesting to note that most of the foreclosed real estate is at the low end of the market. Properties with a value of \$200,000 or less comprised two-thirds of the number of properties in foreclosure during October. Properties with a value of \$300,000 or less comprised 84% of the number of properties. Take a look at the chart on the next page.

This is also both bad news and good news. The bad news is that the biggest glut of properties were likely purchased by those who could least afford a house, and those who were the first to lose their jobs during the recession, and those who are likely the last to be re-hired during the next economic recovery.

Number of Foreclosed Properties by Value



The good news is that these houses are affordable for a new, huge generation of home buyers, the echo of the baby boomers, a fact that should help absorb this inventory.

Where are the Foreclosures?

While the foreclosure crisis is a nationwide problem, the bulk of foreclosed properties are not evenly scattered across the country. The table below shows where 70 percent of the

	# Properties	% of Total	1 of every
US	332,172	100.0%	
CA	66,475	20.0%	201
FL	56,858	17.1%	155
MI	19,288	5.8%	235
IL	16,969	5.1%	311
AZ	16,538	5.0%	165
GA	14,850	4.5%	271
NV	14,205	4.3%	79
OH	13,233	4.0%	384
TX	13,008	3.9%	738

332,172 foreclosed properties were in October.

More than a third of all foreclosures were in California and Florida. Adding Michigan, Illinois, and Arizona accounts for more than half. The remaining four states bring the total to 70 percent of all foreclosures.

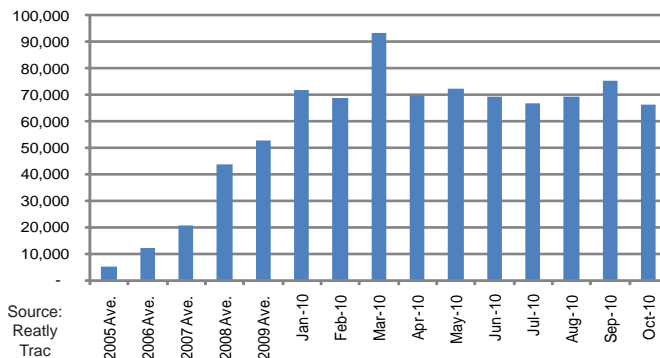
Nevada (NV) has earned a reputation as the foreclosure capital. That is because it has the highest number of foreclosures in relation to the number of houses there. The right hand column of the table shows that 1 of every 79 houses was foreclosed upon in October, which is the highest concentration of foreclosures in the nation. While that may be important to a homeowner or real estate investor in Nevada, other states are a much larger burden on the national economy, notably California and Florida.

We need to keep an eye on California and Florida. Any changes in foreclosure trends in these two states could very well lead to changes for the national economy as a whole. Take a look at the chart of California Foreclosures - Monthly Average.

In 2005, foreclosures averaged 5,138 properties in California. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were

close to 70,000 each month, with a spike of 93,000 in March. Both foreclosures and new default filings dipped in

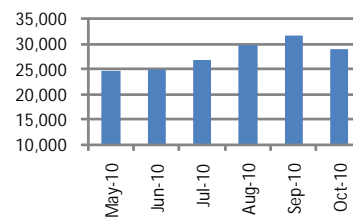
California Foreclosures - Monthly Average



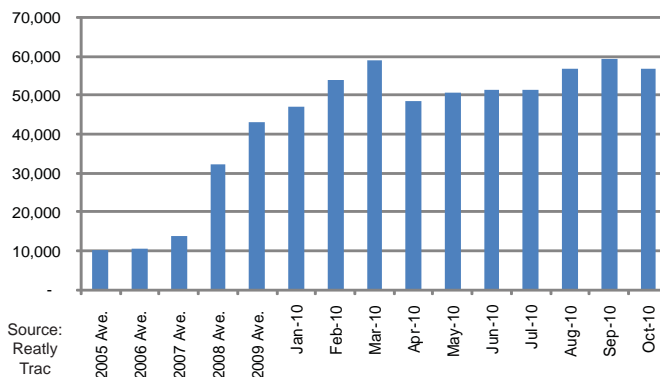
October, which can be attributed to the freeze.

California New Default Notices

The situation in Florida looks similar. Foreclosures climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010,

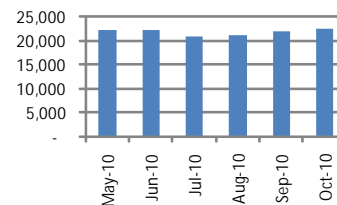


Florida Foreclosures - Monthly Average



and have stayed in the 50-60,000 range through October. New Default notices did not decline, despite the freeze.

Florida New Default Notices



Conclusions

So far we do not see a meaningful change in the high foreclosure trends, either in the national statistics or in California or Florida. However, this situation will not last forever. We will be tracking these foreclosure metrics in these pages of **SoundAdvice**, and we will be among the first to know when the beginning of the end of the foreclosure crisis is at hand. That will mean you can make enormous profits in real estate, as well as other investments that benefit from an economic recovery.

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 a "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 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 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 \$7,293,118 in stocks and to \$1,036,702 in houses.

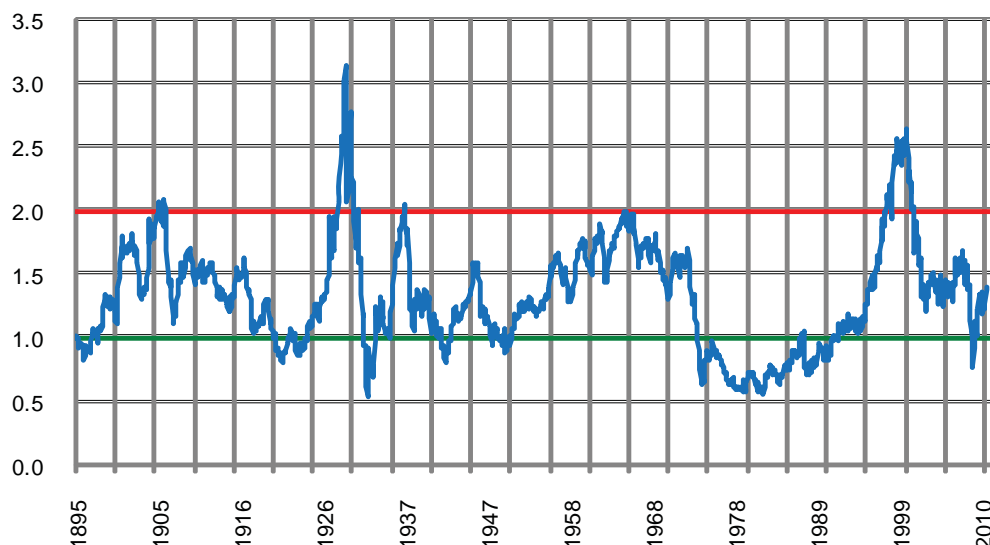
But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$289,781,4721, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the 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. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying the REITs. Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, Real Estate Investment Trust shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.37. 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.

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



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

The Diffusion Index of Leading Indicators: 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. The current reading is 25 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

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 66.7 percent.

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 average return of 22.1 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 during caution periods.

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		

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the SoundAdvice Diffusion Indexes and their track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)

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