

## The Quest for Yield



The *Sound Advice* Portfolio is up 12.1 percent this year, as compared to 6.3 percent for the S&P 500. We have an average profit of 62 percent based on the prices at which each position was recommended.

By the way, *The Science of Making Money in the Stock Market* is now available for Kindles and I pads. Amazon is allowing it to be downloaded for free through August 6, and for \$2.99 after that. Either way, you can pass on a copy to friends and relatives for free. (See page 3.) This is the book that explains all of the **SoundAdvice** indicators, including the Diffusion Indexes and the Risk Indicator, and exactly how they work, along with a detailed history to back up the track records.

-- Gray Emerson Cardiff, Editor

In our July 8 mid-month update, we recommended **RLJ Lodging Trust (RLJ)**. This should prove to be a timely addition to the portfolio. In the wake of Brexit, investors are seeking investments that are normally considered safe, including utility stocks and bonds. However, the current sky-high prices of these traditional hiding places have diminished their yields and make them risky now.

One pocket of value currently being over-looked is the hospitality industry, which has a large growth in jobs recently. We already have a recommended investment in this area: **Hersha Hospitality (HT)**, which is timely now, and offers a solid high yield with growth prospects. (See portfolio updates.)

RLJ also offers a high dividend yield of 5.6 percent which is well covered by funds from operations (FFO) of double the dividend payout. Debt is also low at less than 30 percent of assets.

### Growth Prospects

Since its inception in 2011, RLJ has completed \$7 billion in acquisitions and dispositions. RLJ has a large, geographically diversified portfolio of 125 hotels, branded by Marriott, Hilton, Hyatt, and Embassy Suites with over 20,000 rooms. Seventy-four percent of its hotels are in high-growth areas, including Northern California (11%), Austin (9%), South Florida (9%), Denver (8%), New York City (7%), Chicago (7%), Washington DC (7%), Louisville (6%), Houston (5%), and Southern California (5%).

Management has expertise in real estate portfolio management as well as in acquisitions, and the company generates significant free cash flow to fund acquisitions as well as renovations. RLJ has also started to buy back its own stock. Performance has been particularly good during the last five years as the company has been upgrading its assets by purchasing 30 properties in high growth markets with high barriers to entry. Management expects a significant "ramp up of growth from recent acquisitions".

Rather than traditional full service hotels, RLJ emphasizes "focused-service" or "compact full service" hotels, where only specially chosen services important for guests are offered. The most important amenity is an attractive, modern room offering quality features for the basic necessities – sleeping, bathing, and working. Excluded or minimized are amenities such as large restaurants, spas, and meeting rooms. Overall, the hotels are mid- to up-scale, but with reasonably-priced rooms.

This concept means less square footage, fewer food and beverage outlets, and limited meeting spaces, all of which translates into a larger portion of revenue from the rooms. Yet revenue per available room (RevPAR) is comparable to full-service rates. Accordingly, margins are higher along with the return on investments because of the more efficient operating model.

### Determining the True Value

Like a bond, the value of real estate is based on its yield. The yield is calculated by using the net operating income (NOI) from the real estate, which is the income left over after operating expenses are deducted, but prior to any debt service or company administrative expenses. In real estate parlance, the yield is called the "capitalization rate" (cap rate), and it is simply the NOI divided by the price of the real estate. The math is the same as determining a bond yield: the higher the yield, the lower the price of the bond (or real estate), and vice versa - the lower the yield, the higher the price of the bond (or real estate).

If we are considering investing in a real estate stock, we apply the same principles as if we were buying real estate directly. The first question to ask is "What am I paying for the real estate?" In other words, what is the stock market paying for the real

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	23.75	5.6%	11.6%	6,447.5	40.08	-46.0%
Hospitality Properties	HPT	31.91	6.4%	9.9%	10,638.4	46.20	-36.7%
Hersha	HT	18.90	5.9%	10.1%	2,341.4	27.53	-31.3%
Host Hotels & Resorts	HST	17.74	4.5%	8.7%	18.6	21.20	-16.3%
Apple Hospitality	APLE	20.37	5.9%	7.2%	4,395.5	19.45	4.7%

estate based on the current price of the stock?

We can determine what the stock market is paying for the underlying real estate portfolio by starting with the market capitalization of the company. That is simply the market price of the stock times the number of outstanding shares. (All of the information we need is included in the company's quarterly 10Q reports filed with the SEC.) We then back out the non-real estate assets and liabilities, including any debt. What remains is the price that the stock market is currently paying for the real estate portfolio.

Next we determine the net operating income (NOI) being produced by the portfolio. The trailing four quarters should be used to even out any seasonal fluctuations. To determine the cap rate the market is paying, we divide the NOI by the price that the stock market is currently paying for the real estate portfolio. The resulting yield can be referred to as the "Stock Market Cap Rate".

The table above shows the Stock Market Cap Rate for several comparable hospitality stocks. Notice that there are considerable differences in the group. RLJ has the highest cap rate of 11.6 percent. The lowest is Apple Hospitality at 7.2 percent.

### Main Street Cap Rates

There is Wall Street, which exists in a world of its own, and then there is Main Street where real estate actually trades. During the last 18 months, Hersha has reported several hotel transactions it made at cap rates ranging from 5.4 to 7.8 percent. To be on the conservative side, we can establish a main street cap rate at the high end of this range, of 7.5 percent.

The table shows the value of the underlying portfolios of these companies using a cap rate of 7.5 percent. The column to the right shows the value of the stock if its portfolio were valued with a 7.5 percent cap rate. The next column to the right shows the discount or premium at which the stock is trading based on that valuation.

What becomes evident is that RLJ is trading at the largest discount.

Hospitality Properties (HPT) has the second largest discount. However, this company is externally managed by RMR which has had a troubled history. We recommended an office REIT called Commonwealth REIT (CWH) when it was run by RMR who charged high fees and suppressed value. The value was unlocked when two hedge funds bought shares and orchestrated an ousting of RMR.

(The stock jumped 50 percent the day of the proxy announcement.) Now called Commonwealth Equity (EQC), it no longer has the burden of RMR. As long as RMR continues to externally manage HPT, we do not expect to see significant growth.

The next largest discount is Hersha (HT). While not the largest discount, HT is still trading substantially below the value of its assets and offers strong growth prospects from acquisitions and renovations.

Host Hotels and Properties (HST) is very small, with only 749 thousand shares outstanding, which may lead to excessive volatility. Growth may be limited by its small capitalization.

Finally, Apple Hospitality is trading at a slight premium.

However, the analysis does not end here. The quality and growth prospects of the underlying portfolio have a great deal to do with whether RLJ deserves its discount. It clearly does not because RLJ's management is pursuing growth by upgrading its portfolio into higher growth areas,

### Conclusion

RLJ presents an extraordinary value. It is trading at a substantial discount to its net assets, as well as at a discount to its peers. The discount would suggest a poorly managed company without growth prospects. However, RLJ is quite the opposite. In addition, the dividend yield is high which also lowers the risk profile.

As investors continue to search for high yielding investments, which are becoming scarce, RLJ presents a solid choice with outstanding value, and is likely to benefit in the near term.

### Portfolio Updates

Our model portfolio selections reflect the "Caution" signal in force issued by our Diffusion Index of Lagging Indicators (page 11). With the overall market fully valued, we have reason to be cautious. .

### Energy Selections

The latest data from the Energy Information Administration (EIA) shows US oil production has been declining during the last year. During the week ending July 22, US production was 8.515 MMbbl/d, down 1.095 MMbbl/d from the peak of 9.61 MMbbl/d during the week ending June 5, 2015. According to the Energy Information Administration, demand will be increasing even with low worldwide GDP growth

The Energy Information Administration (EIA) projects that consumption will still rise by 1.2 to 1.5 MMbbl/d in 2016 and 2017 using low GDP growth assumptions.

Recoveries in oil and gas prices have been bumpy in past cycles, but have ultimately translated into stellar profits. This time should be similar. Here are our energy selections, in alphabetical order.

**Chesapeake Energy (CHK)** has taken a beating from the crash in oil and gas prices. CHK's debt load of close to \$10 billion makes it an aggressive investment in the current environment of low oil and gas prices, and the risks increase with an extended period of low energy prices. The company has a portfolio of 8 million net acres of oil and gas assets carried at a book value of \$70 billion.

CHK has good longer-term growth potential if it can survive the current period of low oil and gas prices. The company has been reducing its debt with near-term maturities, and it has a \$4 billion credit facility to tap that matures in 2019. Carl Icahn holds 11 percent of the outstanding shares and has strong influence over management.

**Chevron (CVX)** is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these stages of production, depending on price demand for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. When oil prices are low, profit margins expand from refining. Management has pronounced the annual dividend of \$4.28 per share as "sacrosanct" which provides an attractive yield and limits the downside risk.

On the last trading day of July, CVX reported second quarter cash earnings of 35 cents versus an expectation of 32 cents. However, impairments on properties due to lower oil and gas prices produced a non-cash charge of \$2.8 billion, which more than wiped out the earnings, giving CVX a loss for the quarter.

Looking ahead, Chevron's most significant projects are coming on stream. The Gorgon LNG export facility 100 miles off the northwest coast of Australia recently commenced operating and is expected to reach full production in 6 to 8

months, delivering the equivalent of 90 thousand bbl/d of oil. Chevron's other major project, the Wheatstone LNG project, also in Western Australia, is due to begin production next year. Both of these projects will boost cash flow.

**ICON Energy Fund Class S (ICENX)** is also a diversified way to participate in the recovery with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sectors to capture value, rather than simply depending on rising oil prices. This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management.

**Transocean (RIG)** makes deep-water drilling rigs and leases them to major oil producers around the world. RIG has been sharply impacted because the utilization of its rigs has fallen along with the drop in oil prices. We continue to recommend RIG because of its prospects for survival. The company expects to have positive free cash flow for the rest of 2016, and reports a backlog of orders totaling \$14.6 billion, nearly all of which is for ultra deep water floaters. The long-term profit from RIG should be very good from here.

In July, the company's fleet status report showed that the newly built ultra deep water drillship *Deepwater Proteus* commenced operations on its 10-year contract in the U.S. Gulf of Mexico at a current dayrate of \$498,000. Other platforms were leased, including the *Jack Bates* for two years offshore India at a dayrate of \$127,000. The *Transocean Spitsbergen* and the *Sedco 704* were awarded one well contracts in the North Sea. Estimated 2016 out of service days increased by a net 155 days due primarily to contract preparation and mobilization associated with the *Jack Bates* and *Actinia*, and mobilizing the *M.G. Hulme, Jr.* and *Rig 140* to new contracts. The deepwater floater *Sedco 702* was classified as held for sale.

Deep-water drilling is still a necessary source for the US and the world's oil needs, especially as US fracking drops off.

**Valero Energy (VLO)** is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US,

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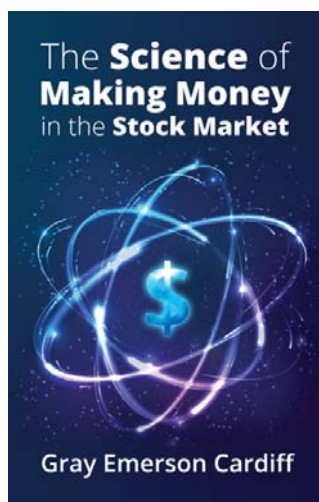
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Canada, UK, and Ireland. Profitability in refining is a function of the so-called “crack spread”, the difference in the amount a refiner pays for crude oil and the amount it sells the resulting refined product which is mostly in the form of gasoline. Fluctuations in these prices compress and expand margins which can make refining stocks volatile and somewhat unpredictable in the short run. In the case of Valero, however, the current valuation is compelling for the longer term (and perhaps the short term as well) in view of the fundamental aspects of the company.

At the end of July, VLO reported second quarter earnings of \$1.07 per share, beating the expectation of \$1.00. The glut of gasoline and diesel products has squeezed refining margins to \$8.93 a barrel from \$13.71 in the same quarter last year. The glut is anticipated to last through the summer driving season.

The glut has caused VLO to decline to an attractive price. Since the glut is temporary, this should be a good buying opportunity.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly.

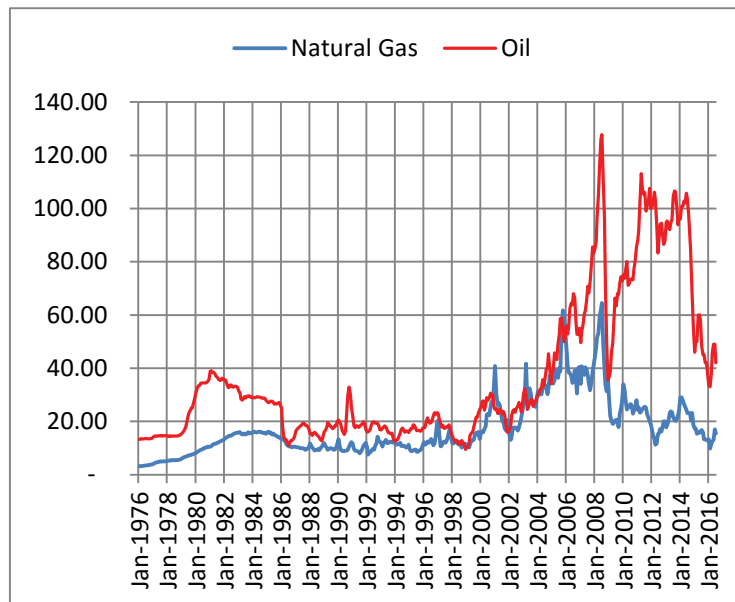
The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$42 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to \$2.67 for one million BTUs, 5.8 million BTUs will cost \$15.50. So the same amount of energy is available for 37 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together, but remain substantially apart. This difference still translates into an expanding natural gas industry.

**Real Estate Selections**

As in the case of bond yields, low interest rates for so many years have pushed down real estate capitalization (cap) rates (the yield before debt payments are considered) to historically low levels. As a result, commercial real estate prices are historically high, and the average real estate investment trust (REIT) does not present a particularly good value.

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



In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising mortgage interest rates. However, this benefit is most likely to translate into profits only on real estate stocks offering an extraordinary value now.

**Hersha Hospitality (HT)** is a real estate investment trust in the hospitality sector, which owns and operates high quality upscale hotels in urban gateway markets. The Company’s 55 hotels totaling 8,654 rooms are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast.

Many of HT’s major properties have been undergoing renovations and not producing their full income potential. Even with ongoing renovations in 2015, the year saw an 18.7 percent growth in funds from operations (FFO). As renovations are completed and rooms are put back on line, revenue and FFO should climb substantially higher. New acquisitions will also contribute to growth.

In late July, HT reported second quarter results. FFO were \$0.89 per share, a 6.2 percent increase from the first quarter, and a 17.1% increase from one year ago. Performance was bolstered by strength in the West Coast, Philadelphia and Washington, DC locations, which saw RevPAR (revenue per available room) grow by 5.0 percent during the quarter. This was offset by weaker pricing power in New York City, giving the whole portfolio RevPAR growth of 2.6 percent. HT is selling at a discount to its hotel assets. Based on the latest trailing four quarters financials, including the most recent 2016

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second quarter, and using 7.5 percent cap rate to evaluate the company's portfolio, we value HT at \$27.53 per share which is 46 percent higher than the current price. The dividend yield of 5.9 percent is attractive and lowers the risk profile.

**Retail Opportunities Investment Corp (ROIC)** is a real estate investment trust (REIT) that specializes in the acquisition, ownership and management of grocery-anchored shopping centers located in densely-populated, metropolitan markets across the West Coast. The dividend yield is attractive which lowers its risk profile.

ROIC began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. As new properties are added, along with tenant upgrades, FFO is bound to continue rising.

In late July, ROIC reported strong second quarter results. During the quarter, ROIC added \$181.8 million of grocery-anchored shopping centers to the portfolio. FFO increased by 17.4 percent over last year's second quarter.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is loaded with good values substantially below NAV with strong growth prospects.

Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value, when making decisions on whether to buy, hold, or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

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

### Medically-Related Selections

This sector is defensive because medical needs persist regardless of financial conditions. The world's demographic aging trends, and the commensurate increase in medical care needs, translate into strong growth prospects for this industry.

**Boston Scientific (BSX)** produces medical products well suited for an aging population. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs.

BSX has more than 900 US patents.

At the end of July, BSX reported strong earnings of 27 cents per share on revenue growth of 16 over the same quarter of last year. The company also raised its earnings estimate to between \$1.07 and \$1.11 per share.

**Pfizer (PFE)** has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. The company is well positioned with several break-through drugs and treatments.

The company believes that the public markets have yet to fully recognize Pfizer's oncology recipes for treating cancer. Pfizer's therapy for metastatic breast cancer, *Ibrance*, has exceeded expectations in treating 28,000 patients.

In July, the FDA granted "breakthrough therapy designation" to a hemophilia treatment developed in a partnership between Pfizer and Spark Therapeutics. This designation expedites the FDA review process of treatments for life-threatening diseases.

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

In July, SYK reported strong second quarter earnings of \$1.37 per share, and raised its 2016 estimate to between \$5.70 and \$5.80 per share..

Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions.

**Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL)** is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

### Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. This is especially true during a recovering economy. Small-cap stocks perform better than large-cap stocks because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually quite profitable. They also tend to be domestic companies without substantial overseas exposure, and therefore are not buffeted by the currency fluctuations

that currently haunt larger companies. Here more than ever, attention to value is paramount.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)** invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), and the ability to consistently grow NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

### Special Situations

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

**Agrium (AGU)** is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products, aimed at increasing the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while population and per-capita income increases. This translates into a need for greater crop output per acre through the use of AGU's products.

Close to three-quarters of AGU's earnings now come from its retail stores offering farm products, and the rest comes from its wholesale sales of fertilizers, mostly nitrogen-based but also from potash and phosphates. This diversification protects AGU from swings in the markets and brings steady sources of free cash flow for future growth.

In July, Agrium announced the purchase of Cargill AgHorizons which will add 18 more retail locations in the US with \$150 million in revenues. Cargill's locations will fill in the corn belt where Agrium's were scarce, and add leverage to its distribution network..

**Alcoa Aluminum (AA)** kicked off the earnings season in July with a pleasant surprise of 15 cents earnings per share. In late June, Alcoa officially filed to split its upstream and downstream operations into two separate companies. The upstream operations of mining bauxite, alumina, aluminum, along with cast products and rolling mill operations retain the Alcoa name and the stock symbol "AA".

The new downstream company will be called Arconic, with the stock symbol of "ARNC" and will combine its value-added businesses to precision engineering along with advanced manufacturing the aerospace structures, jet engines, automotive and commercial transportation markets.

The split is expected to occur in the last half of this year, pending a favorable IRS ruling. Splitting will enhance management's ability to focus on core operations, allocate capital, target investment opportunities, and customize employee incentives and recruitment.

**Disney (DIS)** has built an empire in family-oriented

entertainment with its charming film characters, consumer products, and theme parks. CEO Iger's decisions over the past decade to acquire Marvel, Lucasfilm, and Pixar are paying off. Disney plans several more episodes and related offshoots of the *Star Wars* franchise into 2019. Another *Star Wars* movie is due to be released this December. Also in the pipeline are more *Indiana Jones*, *Avengers*, and *X-men* movies. *The recent success of The Jungle Book* unlocked a pipeline of live action fairy tales including a sequel to *The Jungle Book*, a *Tinker Bell* movie, and a spinoff of *101 Dalmatians*.

The success of the movie franchises and theme parks will add to investor enthusiasm and should make DIS less dependent on its cable TV stations, especially ESPN, which are under pressure from cable platforms offering skinnier bundles with fewer required stations.

**Ford (F)** is in our model portfolio because it is an extraordinary value. Ford's new all-aluminum F-150 truck, which gets close to 30 miles to the gallon, has been Ford's best-selling vehicle in the US for 34 consecutive years, and the company's most profitable product. On the cost side, Ford has been reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by the end of 2016, which will continue to save billions through economies of scale and give Ford more ability to adapt to changes in demand.

At the end of July, Ford reported a disappointing second quarter. Although revenue was up 6 percent to \$39.5 billion, net income fell 9 percent on flat sales in the US and China, which translated into per share earnings of 52 cents, missing the expectation by 60 cents. Results during the rest of the year will be dampened by the expensive launch of Ford's new aluminum-sided Super Duty pickup truck. As the top-seller of vehicles in the UK, Ford expects to lose \$145 of sales because of the uncertainty over Brexit.

CEO Mark Fields said the company is taking actions to improve its results, including cutting production to meet demand and making sure all markets have the right mix of vehicles.

All of this negativity has the stock selling at a huge discount to the rest of the market. The dividend yield is close to 5 percent which lowers the risk.

**Freeport-McMoRan (FCX)** is the world's largest copper producer. It also has significant oil and gas assets in the Gulf of Mexico which it acquired at the top of the market in 2013. This was particularly unfortunate because FCX took on a large amount of debt to make the acquisition. The added leverage, along with sinking prices on these commodities, decimated FCX. The production from these wells is now increasing.

FCX began moving up in the final days of July since it reported a smaller loss of 38 cents per share in comparison to a \$1.78 loss a year earlier. The company also announced significant progress on selling non-core assets in order to reduce its debt burden. After reaching a deal to sell its stake in an African copper operation to a Chinese mining-and-processing firm for \$2.65 billion, Freeport announced a \$1.5 billion stock offering, the proceeds of which would be used to reduce debt further. During an earnings conference call,

CEO Richard Adkerson said these moves clear the path for Freeport to get its balance sheet in order without being forced to sell its highest quality assets. He added “We’re not forced to do anything now to meet our financial objectives. Now we can step back and deal with these other things strategically rather than as financial imperatives. Freeport is still open to all strategic moves, whether that means selling assets, or selling the company.”

During the question and answer portion of the call, an analyst asked whether Freeport is actively considering putting itself up for sale or is merely open to offers. Adkerson said “We’ve told the world that if there is some way of generating shareholder value now that’s reasonable and attractive, there is not going to be barriers to our company considering it.”

Carl Icahn is the largest FCX shareholder with 88 million shares, which means moves are being made under his watchful eyes.

**NCR Corp (NCR)** makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

Blackstone’s recent \$820 million investment in NCR preferred stock that is convertible into NCR stock at \$30 is evidence that this savvy private equity and advisory firm sees that NCR has significant value above \$30.

At the end of July, NCR reported second-quarter net income of \$76 million, after reporting a loss in the same period a year earlier. Earnings were 72 cents per share.

We have noted that NCR is an undervalued stock. Prior to Brexit, NCR expected its 2016 earnings to be in the range of \$2.90-\$3.00. At the end of July, the company said it still expects full-year earnings to be in the same range. The current stock price puts it close to 11 times earnings, far below the market average.

**Symantec (SYMC)** is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

Earlier this year, Symantec sold its subsidiary Veritas to the Carlyle Group. The sale transforms Symantec into a pure-play security vendor with fresh capital for acquisitions and R&D to bolster growth. This new-found focus and capital should launch a new growth phase for SYMC. The restructuring is also aimed at reducing operating expenses by \$400 million annually.

In July SYMC announced the next version of its Control Compliance Suite, security assessment system that provides users with the ability to run security and compliance assessments on their servers, endpoints, and critical network infrastructure.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy

balance sheet for growth in strategic markets. Two recent acquisitions of Coffey and INDUS corporations have swelled TTEK’s backlog of contracts and increased prospects for more Federal contracts in the IT sector. Three contracts were added in the most recent quarter for \$144 million. The company’s backlog is now \$2.3 billion, which has increased by 21 percent during the last year.

In late July, TTEK reported net revenue of \$496 million for the company’s fiscal third quarter, which translated into earnings per share of \$0.50, up 16% year over year. The quarterly dividend has been increased to \$0.09 per share. The Company has \$25 million of stock to buy back under its previously approved \$200 million share repurchase program.

In July, Tetra Tech also announced recipients of its 50th Anniversary Global Clean Water Fund grants, a fund established in partnership with Engineers Without Borders (EWB), to support programs that provide clean water for communities in need around the world. The grants will help bring clean water to villages in remote areas of Cameroon, Malawi, Mexico, Brazil, India, and Timor Leste.

The company expects full-year earnings in the range of \$2.70 to \$3 per share, which puts the price/earnings ratio between 11 and 12 – a substantial discount to the rest of the market.

**Xerox (XRX)** is continuing to transform from a seller of printers and copiers to a company providing information technology (IT) services and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenue. XRX will be splitting into two companies by the end of the year; one with the printers and other equipment and the other offering the IT services. The company predicts that the split will save \$2.4 billion during the first 3 years. Carl Icahn, who holds 82 million shares, believes XRX is undervalued and believes the split will improve management’s efficiency and focus.

On the last trading day of July, XRX reported earnings of 30 cents a share, beating the consensus estimate of 25 cents. At close to 10 times earnings, we continue to emphasize that XRX is very cheap relative to the rest of the market.

## ETFs for Rising Interest Rates

We have been recommending three ETFs designed to benefit from the normalization of interest rates and long-term bond yields. The Brexit backlash lowered the prospects for rising US bond yields for the near term, making US Treasuries an attractive hiding place for uncertain capital. At this writing, long-term Treasury bond yields are currently 2.18 percent, down from 2.31 percent at the end of last month just after the Brexit vote.

As one of the least affected countries, the US economy should continue to improve after the shock of Brexit wears off. The way the US stock market recovered 3 days after the Brexit vote is an indication that continued improvement in the US economy is ahead which will ultimately lead to increases in inflation over the longer term. In addition, the string of 100 percent readings from the **SoundAdvice Diffusion Index of**

**LAGGING Indicators** (page 11) is telling us that a rise in interest rates is on the horizon.

Because the current prices of these ETFs are so low, they present compelling long-term investments, even if we may need to wait a couple of years. .

These ETFs differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

The **Direxion Daily 20 Plus Year Bear 3 Shares (TMV)** uses 3:1 leverage.

The **Proshares UltraShort Lehman 20 Plus Year Treasury (TBT)** uses 2:1 leverage.

The **Proshares Short 20 Plus Year Treasury (TBF)** uses no leverage.

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds. The prices of these ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. In its December meeting, the Federal Reserve's Federal Open Market Committee (FOMC) unanimously decided to begin normalizing interest rates. As part of the FOMC's economic projections, each of the 17 members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot", and medians are taken to formulate the Federal Reserve's official prediction.

The most recent Dot Plot was taken at the June meeting. There was a sharp difference in the predictions among this group of informed FOMC experts. The lowest prediction was that the Federal funds rate would end 2016 at 0.625 percent. The highest was 1.375 percent.

In the spirit of being conservative, we can use the average of the lowest half of the predictions of the June Dot Plots (8 of the 17). These averages predict that the Federal funds rate will be 0.69% by the end of 2016, 1.31% by the end of 2017, and 2.03% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same as today's real return), long-

term Treasury bond yields would be yielding 2.62% by the end of 2016, 3.24% by the end of 2017 and 3.96% by the end of 2018.

Here is what would happen to each ETF:

TMV would rise to from \$15.56 to \$19 by the end of 2016, to \$28 by the end of 2017, and to \$40 by the end of 2018.

TBT would rise from \$30.25 to \$35.7 by the end of 2016, to \$45 by the end of 2017, and to \$57 by the end of 2018.

TBF would rise from \$20.57 to \$22.3 by the end of 2016, to \$25 by the end of 2017, and to \$28 by the end of 2018.



**The Erosion Factor**

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

TMV would decline to \$15.1 by the end of 2016 (3%), and to \$14.1 by the end of 2017 (9.3%).

TBT would decline to \$29.8 by the end of 2016 (1.4%), and to \$29.9 by the end of 2017 (4.4%).

TBF would decline to \$20.5 by the end of 2016 (0.4%), and to \$20.3 by

the end of 2017 (1.3%).

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

**Hedging the Portfolio**

Since June 2015, our *Sound Advice* Diffusion Index of Lagging Indicators (page 11) has been issuing a caution signal. At times like this, it is vital to confine portfolio selections to special situations and focus on value.

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

Income With Growth	Symbol	Price / NAV	Yield	Action	Limit
Hersha Hospitality Trust	HT	\$18.90	5.93%	BUY	\$21.00
Retail Opportunity Investment Corp	ROIC	\$22.83	3.15%	BUY	\$24.00
RLJ Lodging Trust	RLJ	\$23.74	5.56%	BUY	\$25.00
Diversified Growth					
Agrium	AGU	\$90.76	3.86%	BUY	\$99.00
Alcoa	AA	\$10.62	1.13%	BUY	\$11.00
Boston Scientific	BSX	\$24.28	0.00%	BUY	\$25.00
Disney	DIS	\$95.95	1.43%	BUY	\$107.00
Ford Motor Company	F	\$12.66	5.53%	BUY	\$15.00
NCR Corp	NCR	\$32.97	0.00%	BUY	\$33.00
Pfizer	PFE	\$36.89	3.25%	BUY	\$37.00
Stryker Corp.	SYK	\$116.28	1.31%	BUY	\$122.00
Symantec	SYMC	\$20.43	1.57%	BUY	\$21.00
Tekla Life Sciences Fund	HQL	\$19.07	0.00%	BUY	\$20.00
Tetra Tech	TTEK	\$32.93	1.09%	BUY	\$34.00
Third Avenue Real Estate Value Investor	TVRVX	\$30.60	1.44%	BUY	\$32.00
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$20.77	0.00%	BUY	\$22.00
Xerox	XRX	\$10.30	2.72%	BUY	\$12.00
Energy/Natural Resources					
Chevron	CVX	\$102.48	4.18%	BUY	\$110.00
Fidelity Select Nat. Gas Fund	FSNGX	\$24.52	0.00%	BUY	\$27.00
ICON Energy Fund Class S	ICENX	\$12.05	0.00%	BUY	\$13.00
Transocean	RIG	\$10.99	0.00%	BUY	\$13.00
Valero	VLO	\$52.28	4.59%	BUY	\$60.00
Aggressive Growth					
Chesapeake Energy Corp	CHK	\$5.42	0.00%	BUY	\$5.50
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$15.56	0.00%	BUY	\$24.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$20.57	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$30.25	0.00%	BUY	\$39.00
Freeport-McMoRan	FCX	\$12.96	0.00%	BUY	\$15.00
S&P 500 ProShares Ultra Short ETF	SDS	\$16.56	0.00%	BUY	\$21.00

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

#### Notes to the table:

Prices are as of 7/29/2016. See our website for live pricing and buy limits:

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

The right hand column is the highest recommended price limit for purchases.

#### General Comments:

Our statistics are based on the assumption that \$10,000 is invested in each position. When a new position is added, we assume the same \$10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, as we have done over the years, we assume another \$10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

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

## Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool the SoundAdvice "Risk Indicator," since it will allow us to locate the point at which prices are so high when

compared to competing markets that they have come loose from their moorings and are on the verge of declining or under performing the other market.

What is too high? When stock prices are very high relative to house prices, the SoundAdvice Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the SoundAdvice Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$12.8 million in stocks and to \$1.54 million in houses.

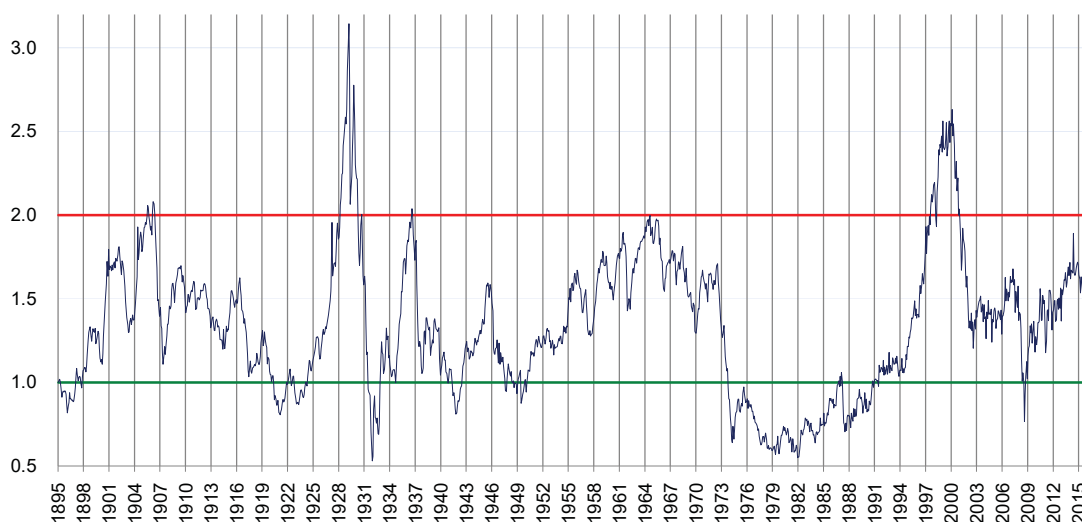
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$508 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

### The SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.76. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

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

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

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

The SoundAdvice Diffusion Index of **LAGGING Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reading reveals that the US economy is strong enough to put upward pressures on interest rates.

We have been operating under a "Caution" signal since the June 2015 release of the May lagging economic indicators. This was just after the S&P 500 peaked at 2,130.82 on May 27, 2015.

It is worth noting that the SoundAdvice Diffusion Index of **LAGGING Indicators** hit 100 percent again in May and June (the most recent data), and will continue to do so in July and August unless there is a significant decline in the underlying lagging economic indicators. This string of 100 percent readings is confirming our caution signal.

### Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 2.7 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.1%		2.7%

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 paid subscription, and you will also receive an updated copy when you renew your subscription.)

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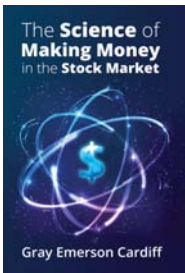
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