

# SOUND ADVICE

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We believe the market is at a watershed moment, the beginning of a long-cycle upswing in equity prices that will push shares and funds higher in the coming years. At this juncture, it's arguable that all investors need do is buy a clutch of complementary cost-efficient index funds and sit back. That's fine, especially if you subscribe to efficient markets and the impossibility of surpassing the average market return. We disagree. Efficient market theory fails in the real world, and we have the performance figures to prove it.

As Ben Graham observed, in the short-run the market is a voting machine but in the long-run is a weighing machine that ultimately pays not what the emotional market's whim sets but what the company's assets are worth. Most corporate mergers, for example, result in bad deals made by acquisitive corporate titans who instinctually pay too much for a "must-have" asset.

We've written about how sports teams with the fattest payrolls rarely win the big prize. Last week, the *New York Times* applied that point of view in comparing the Yankees' Alex Rodriguez, who has a 10-year contract with a potential price tag of \$305 million (\$33 million this year) and at 33 is closer to starting to decline as a player to Tampa Bay's Evan Longoria, who also is in the second year of a 9-year contract that totals \$45 million. He's 23. Rodriguez due to injury has not played this season, while Longoria leads the league in RBIs. Rodriguez's reputation has been dented by steroid use. At this point, which one would you want to own?

—Gray Emerson Cardiff

## Supercycle Six

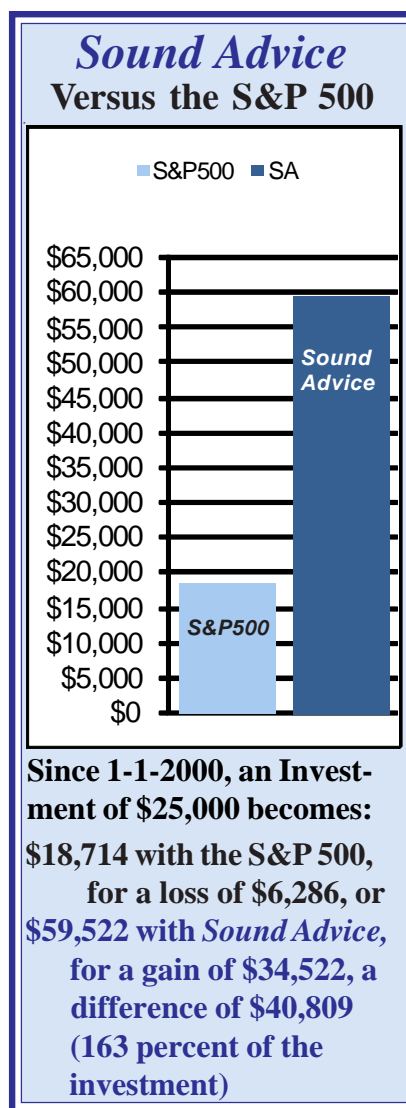
Two months ago, we titled this cover essay "Approaching a Buy Signal." Since then, amid bad and worse news about GDP, unemployment, continuing problems in the credit markets and expanding dismay among both consumers and corporate leaders, we watched our Excel spreadsheets move toward that watershed moment.

Indeed, we were waiting not just for a cyclical Buy Signal, of which we have had 11 since 1974, but for a much more important inflection point. First, our Risk Indicator, which tracks the glacier-like movements of equities versus residential real estate, in November 2008 moved below 1, something we had not seen in 17 years.

At that point, we turned to our Diffusion Index of Leading Indicators to generate a Buy Signal. We now have that complementary signal, which marks the end of Supercycle Five that began in 1974 and the start of a new Supercycle.

In *The Science of Making Money in Turbulent Markets*, the most recent version of a book first published in 1988, we track five Supercycles, long-duration secular trends, the first beginning in 1895, and the briefest of which lasting a decade (Supercycle Three: 1933-1943). Now we have the coincidence of both the Risk Indicator falling below 1 (after piercing 2 in 1998) and the Diffusion Index of Leading Indicators hitting zero.

For us, this event is especially significant, since this is the first time we are seeing in these pages the birth of a Supercycle. Though we have observed historically how profitable following the cyclical Buy



## Birth of a Supercycle

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and Sell Signals generated by our diffusion indexes can be, this is our first opportunity to measure the start of a Supercycle in real time.

We encourage you to review your copy of *The Science of Making Money* to get a more detailed explanation of what all this means, but here are the salient aspects for both the Diffusion Index of Leading Indicators and the Stock Market Risk Indicator.

There are four data points underlying the Diffusion Index of Leading Indicators: unemployment, building permits, vendor performance and the spread between the Federal Funds Rate and the 10-Year Treasury Note.

These figures, selected from 10 leading indicators monitored by the Conference Board, provide early evidence for economic swings. We use them to identify low points in the economy, which usually coincides with investors abandoning equities, because the economy is lousy. Provided the readings at the end of a six-month period are lower than at the start, we read this as a Buy Signal.

It's easy to grasp why rising unemployment, diminished building permits and vendors' ability to meet demand indicate a flaccid economy. It takes a moment of thought to appreciate why the rate spread also hints at a slowed economy: the spread between long-term and short-term rates narrows during economic contractions for several reasons: first, neither businesses nor consumers are confident enough to borrow, which removes upward pressure on rates. Second, the Federal Reserve pushes short-term rates downward in order to stimulate the economy, and in extraordinarily tough recessions, such as now, also targets longer-term rates.

Vendor performance fell into place last September and unemployment and building permits followed in October. Only the rate spread did not fall into place despite the Fed starting to lower short-term rates in mid-2007. Indeed, had the Fed not forced short-term rates lower so far and so fast, we might have gotten our Buy Signal sooner. We were projecting that an "Aggressive" signal was around the corner in our February and March issues just as the bottom was forming for stock prices.

The Risk Indicator is a much more abstract measure, and depends on shifting tides in investor preferences. Without going into its nitty-gritty, the RI compares

prices for equities (S&P) and residential properties (new home prices) adjusted for inflation. Our research stretching back to 1895 demonstrates that when prices for one or the other of these two primary investments grossly exceeds the other, it marks an inflection point for each. When stock prices soared in the last 1990s, we got just such an imbalance. Now, even though prices for both stocks and housing have plummeted, the fall for equities has been far more severe. The S&P from its top on 2007 to its low on March 9th was 57%, while housing prices as reported by the Census Bureau have fallen from 23.2% from their March 2007 high.

Are we giving you a 100% guarantee that the market is now ready to start flowing profits? No. We do not claim infallibility, but we do trust in our indicators. What could frustrate the extended bull market Supercycle Six forecasts?

The most troubling worry is that this recession and bear market are not your garden varieties. Instead, they occur during and are amplified by a severe banking crisis. We have not seen its like for decades, and that includes the 1980s' S&L crisis and the 1990s' Latin American debt debacle. The mantra "It's different this time," which invariably is heard at market extremes, encourages seers to discount any evidence that the environment could be improving.

The last time market gurus were so adamant that "It's different this time" was during the runup to the great bubble burst of 2000 when they swore that New Era economics did not merely make a recession unlikely but declared that the business cycle itself had been vanquished. We know how that worked out.

We believe that it never is different, and are going to trust our indicators. We are moving our stance from caution to aggressive, which explains why we are focusing this month's issue on the most growth-oriented segment of our portfolio: technology and telecom stocks.

Because Supercycles don't get born every day, year, or decade, we decided to set aside what we planned for this month's cover essay, a report on how our Five for 2009 portfolio presented last November is doing at its six-month midpoint. We'll address that fully in the June issue, but we can report that as a group the quintet is up 33% versus -2.8% for the Dow, 6.4% for the S&P and 14.7% for the techcentric Nasdaq. **SA**

# Tech and Recovery

After a deep bear market, it's natural to presume that any rally, even as robust as this one, is just a trap designed to suck investors back in before the market shows its true nature and resumes its downward path. As we make clear in this issue, we believe the market is not deceiving us and that what we are seeing not only is the first up leg for stocks but also is a harbinger of better times for the economy.

This month, we want to hone in on our technology positions, since as an economic recovery does materialize, these companies should shine.

Technology stocks in general have been more resilient, perhaps even predictive, this year than most other market segments. The techcentric Nasdaq started its recovery sooner and showed positive returns sooner than the rest of the market. The chart to the right tracks how XLK, the SPDR ETF for tech has performed since the November 20th market bottom (which was followed by a rally that unraveled).

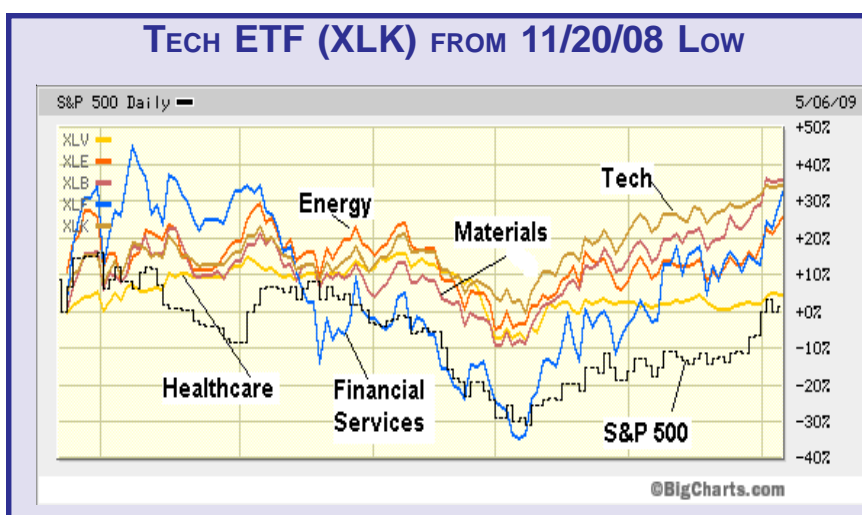
The big tech winners during the run up have been hot shots like Apple, Google and Research in Motion. These companies provide products or services that consumers love. Investors are just as passionate about their shares as they are about their I-Phones, Blackberries and Google searches. Consequently investors are happy to pay a premium to own these shares. We don't pay a premium for others' enthusiasm.

Our five positions hardly are cutting-edge, and tend more toward old tech, which means these companies provide meat-and-potatoes products that prosper during economic expansions. With one exception, they have lagged not just the hotshots but the Nasdaq itself.

Two are software companies, **Microsoft (MSFT—Nasdaq)** and **Symantec (SYMC—Nasdaq)**, one is a semiconductor designer and manufacturer, **Maxim Integrated (MXIM—Nasdaq)**, one is a storage company, **Western Digital (WDC—NYSE)** and one

is a service and IT company, **Xerox (XRX—NYSE)**.

**Microsoft (MSFT—Nasdaq)** is as good a place to start as any, since during the late 1990s tech boom, the company along with Intel, came to epitomize the PC culture that carried technology shares to incredible heights. Microsoft, so omnipotent that it was under threat of being broken up, crested in November 1999 at around \$45 and bottomed along with the rest of the market on March 9th at \$15.15. The spread between that 1999 high and the March 2009 low, however, is nowhere near as wide as the change in Wall Street's attitude toward the world's still dominant software company.



A decade ago, a federal judge was weighing whether the Microsoft juggernaut represented the same monopoly threat to competition that AT&T had posed in 1984 when it was broken up by court order.

Microsoft escaped a breakup, but continues to enjoy a dominance that borders on monopoly when it comes to computer operating systems and application software. But that dominance is hardly guaranteed.

There are rival operating systems, most prominently the Leopard OS for Apple computers and LINUX, a more generic system. Then there is software piracy, particularly in emerging markets, that cheats MSFT out of revenue.

However, the most profound challenges to Microsoft come from the Internet. Non-Microsoft web browsers

## Sound Advice on Technology Stocks

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like Firefox and Safari can be installed easily, and unlike a non-Windows Operating System, does not require buying new application software. But the biggest potential threat comes from cloud computing, which relies not on applications installed on individual PCs but to applications and processes maintained on central computers that are accessed over the Internet. Competitors, especially Google, keep on introducing applications like free word processing and free spreadsheets, which are not as multifunctional as Microsoft products, meet most needs. What is especially frustrating for Microsoft is not just that Google is making inroads into what has been MSFT's core business but that Microsoft has failed to make similar incursions into Google's dominance in online advertising revenues.

But that might change should Microsoft partner with Yahoo! either as regards to online advertising or through an outright acquisition, something that is much less likely than when Yahoo! management spurned Microsoft's offer last year. Perhaps thinking about Microsoft as a software company with aspirations to match Google on the Internet misses the real dynamic in a digital era. Microsoft wants to be a player across the digital spectrum: from computers to the Internet to gaming to all forms of entertainment.

This past quarter, though Microsoft did not disappoint on earnings, sales were down 5.6%, the first time that has happened to MSFT in its 23-year history as a public company, and it had to use cost cutting to help. In all its product lines, only its server and tools business managed to grow sales (+7%), which pales next to the 16% loss in its Windows division and 14% loss by its Internet operations. The weakness for Windows reflects weaker computer sales, but also might be influenced by buyers holding off in expectation of a new Windows Operating System due toward the end of this year.

We do not expect Microsoft to regain the silly valuations (1999: P/E = 74 and P/S=30) seen during tech's late-90s heyday when earnings were less than half than they were last year and sales 35% lower. To get to a significantly higher share price all MSFT needs to do is merely match the S&P's average P/E (16.4). With a new iteration of Windows due to roll out later this year, that match is within reach, especially if the global economy stops deteriorating. There's also a

modest 2.6% yield. We recommend buying MSFT up to \$24.

**Western Digital (WDC—NYSE)** was at one time as yoked to the PC as was Microsoft and still derives 42% of its sales come from units installed in desktop computers. However, just as MSFT has branched out into consumer entertainment and other applications for its software, Western Digital has expanded its presence into entertainment and other consumer products, which might explain why, even though it fell hard in 2008, it has added 107% versus 10.3% for the Nasdaq.

In fact, even while tech stocks topped out in November 2007, WDC kept sailing higher till last June, six months afterward. Western's persistent strength was shared with other hard drive makers, though Western has handily outperformed its competitors, including its larger rival, Seagate.

Western's first quarter numbers not surprisingly were glum with unit sales down by more than a third. However, they exceeded analysts' expectations. Thanks to some remarkable efficiencies, which included downsizing its labor force, the company generated \$249 million in free cash flow. Sales for computer memory storage are very competitive, and there are few if any durable advantages.

Microsoft, for example, retains customers when they upgrade because to switch operating systems and applications would be expensive. Hard drives enjoy no such proprietary advantage. Shoppers, whether they be builders of computers or consumers swapping out hard drives or adding auxiliaries, buy the most for the least. There is no loyalty. Furthermore, when one manufacturer comes up with a new product, competitors are just a half step behind. Western's advantage has been its flexibility in ramping up for new products and bringing them out at rock-bottom prices.

So, why have the disk makers, in a cut-throat industry, prospered even while their revenues and profits decline? In part, investors see that even as hard drive capacity soars and cost per-gigabyte slides, demand for storing pictures, movies and other digital media appears insatiable. Rather than a shrinking market for what Western designs and manufacturers, uses for digital memory will continue to expand in both the commercial and home markets. However, the major driver will be a revived global economy. Even after its strong performance since the November low, Western

## Sound Advice on Technology Stocks

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continues to trade at a discount to other hard drive makers, an anomaly given how efficient management has been. Western, admittedly an “old tech” stalwart trades at a discount to the S&P 500’s price ratios. For that matter, Western Digital compared to its own historical valuations—even at a relatively elevated share price—trades at ratios lower than anything we’ve seen this decade with the exception of 2008’s truly miserable numbers. We recommend buying WDC up to \$26.

**Symantec (SYMC—Nasdaq)** drew our attention originally after it acquired Veritas in 2005 in a deal panned almost universally for being too expensive and too divergent from the personal computer security business that had made Symantec so successful. At the time the deal was consummated, SYMC traded around \$34 but by the time we recommended the shares three years ago, as investors dumped their positions and Symantec fumbled with Veritas, the share price was nearly cut in half. We thought it was time to buy.

The core criticism was that Veritas, which was a leader in large scale storage and management of computer data, did not dovetail with Symantec’s business that was built around security and diagnostic software for consumer and small to medium sized businesses. Veritas also was a slower grower. Though we acknowledged these dings, we thought the price— even for this mismatched pair of companies— was cheap. Also, we thought that the match was not all that terrible, and imagined Symantec, were it able to bring together its expertise in security software with the needs of large scale data management, could develop a very lucrative business. We also liked that the shares were trading at tantalizing low valuations. For us it was an opportunity to make money from OPM (Other People’s Mistakes). The number of big mergers that produced the benefits management assert at the time is trivial compared to those that don’t. More often, they turn out to be disasters. We like to pick up good companies when that reality sets in.

Recently, Symantec had moved back to about what we paid in our original recommendation, not too bad given what has hit the rest of techland. The shares, though from the time of the Veritas deal to November 2008 lagged most tech stocks, had been outpacing the

market since then. Going into the quarterly earnings call on May 5th, Wall Street was optimistic SYMC would meet or exceed estimates. In fact, Symantec did beat analysts’ expectations of 35 cents per share earnings by three cents, though revenue fell short of expectations, which means that Symantec squeezed out those added earnings though cost cutting. Management was not reassuring about the next quarter’s revenues, which convinced shareholders to run. The market, in its wisdom, since that announcement has dropped the shares 15%.

It’s a nice chance, we think, to start or add to a position, since Symantec is well situated to take advantage of the ever expanding ways we have to communicate digitally (I mean, who even knew what Twitter was 12 months ago?) and the growing realization that bad guys are intent on mischief not just on consumers’

data but corporate and government sites. You can understand why customers keep on buying what Symantec sells. If Symantec can suffer modest declines in sales during a deep recession, how well might it do during a period of expansion? We expect to find out and recommend buying SYMC up to \$19.

**Maxim Integrated (MXIM—Nasdaq)** drew our attention originally in 2007 when, after a robust run-up, chip makers were again depressed and share prices fizzled as Wall Street worried about slumping demand and overcapacity. In addition, Maxim management was under a dark legal cloud for abusing how it priced options for employees. This meant it was unable to file quarterly reports to the SEC until it could restate earnings from previous quarters to reflect how those options should have been priced. Because of its failure to file, Maxim shares were removed from the Nasdaq and traded on the Pink Sheets, a marginal market populated mostly by shaky and often shady companies, neither of which describe Maxim.

When we recommended the shares, we believed their valuations were indicative of a trough in the semiconductor business. Indeed, they looked just as weak as they had when the entire tech sector had bottomed in 2002 before the group shot higher.

As it turned out, we were wrong. There was no

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## Sound Advice on Technology Stocks

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upturn. Whatever recovery might normally have occurred as the semiconductor cycle turned upward was obliterated by the current recession that the NBER dates to December 2007.

Not surprisingly, Maxim's revenues and profits have contracted over the last two years. For example, in its recently released results for the first quarter, Maxim saw sales decline by 17.3% from the previous quarter and, when compared to the first quarter of 2008, the drop was 30%. Instead of profits, there was a nine cent per share loss that followed a 12 cent loss in the previous quarter. Twelve months before, the shares earned 19 cents.

Against this we note that orders shipped to mobile phone manufacturers rose as did shipments to notebooks and displays. There was also good business from China as part of its infrastructure expansion. Management has been closing facilities, reducing expenditures and doing everything necessary during the downturn. The only expense that has remained constant has been the dividend, which last quarter was increased to 20 cents for a yield of 5.4%. Maxim can do this for several reasons. First, it has zero debt, which results in nice cash flow and the ability to support and even expand the distribution during a difficult period.

The arguments we made in 2007 have changed not at all. The valuations are still strikingly cheap given the company's historical numbers, and compared to its competitors such as Analog Devices, it is also cheap. We recommend buying the shares up to \$16.50.

**Xerox (XRX—NYSE)** is at first glance hardly a high-tech company. Like "Frigidaire" or "Polaroid," Xerox is so identified with single product, the copying machine, that we easily forget that at one time the Xerox copier was a technological marvel. Today, Xerox still describes itself as being in the "information technology" business, but as management observes it's "Big I and little t," meaning that Xerox's technology, which extends beyond copiers, is meant to enhance how companies handle information, something that Xerox accomplishes with its printing and document management products.

Which is not to say that Xerox products are not technological marvels. Though Xerox still produces the workhorse black and white office copiers that

they pioneered, most of that relatively low-priced business has been ceded to Asian manufacturers. Xerox instead is focusing on color printing and large scale printing projects.

However, in a recessionary economy companies are cutting back on their use of copiers and printing machines and are shying away from paying for more expensive color printing. If you presume the global economy will remain in the doldrums for the foreseeable future, our argument, which turns on demand returning as the world shifts out of reverse, makes no sense. However, if you want to buy an essential building block of commerce, Xerox provides just that opportunity.

During recessions, smart managers hunker down and also take advantage. Looking at the first quarter results testifies to hard times. Sales were down 28.5%, and though service, outsourcing and rentals also slipped, they declined less, down 11%. That difference is not surprising, since client companies have to maintain what they own and lean toward leasing rather than buying equipment.

One area we always check closely for Xerox is Research & Development, which though down on a dollar basis year-over-year is slightly higher on a percentage basis (5.7% vs. 5.1%). Xerox continues to focus on color printing, which it wagers will come down in cost over time and become the dominant medium. We expect similar results from XRX's digital printing lines.

Xerox before the recession hit had been expanding its network of retail dealerships that provide sales and service to medium and small-sized businesses. In 2007 it acquired Global Imaging, which addresses this market and is adding other competitors to its stable. We expect that in a reviving economy this investment will pay off.

In terms of valuations, Xerox is attractive. Like the tech companies discussed above, XRX sports Price to Sales, Price to Book and Price to Cash Flow that are lower not only than what we've seen for the past decade but also lower than its competitors. Price to Earnings is higher than it has been historically, a function, we believe, of write offs in addition to diminished sales. We recommend buying XRX up to \$9.[SA](#)

### Portfolio Updates

Last month, we tried to discourage any expectation that share prices would repeat the results reported then. Our portfolio on an issue-over-issue basis then was up 27.9% compared to the S&P's 23.3%. You would have had to be nuts to predict more of the same. We counseled moderation. This month, the issue-over-issue performance did fall short of last month's. The S&P is up 10.3%, better than the Dow's 5.7% and the Nasdaq's 7.2%. *Sound Advice* also failed to match last month, turning in a still not too shabby 17.5% total return. For the year, our equally weighted portfolio is up 19.6%. If you weight the portfolio to account for those positions we have recommended more than once in the past, the year-to-date return is 24.9 percent.

**Leucadia**, the April recommendation, soared 49.8% for two primary reasons. First, as we were able to squeeze in to our recommendation at deadline as the news broke, Australian regulators finally let Fortescue Metals, in which Leucadia holds a major position, sell new shares to a Chinese smelter, a primary customer, for its iron ore, and thus stabilize its balance sheet. Furthermore, that deal reminded the market how much Fortescue depends on China, and since much of the rally in natural resource stocks has been built on surging demand from China, where it appears infrastructure projects, part of Beijing's stimulus program, are having a strong effect. The second reason, though its much less tangible, is expectation that Leucadia, which has a long history of taking advantage of dislocations in the pricing of financial assets, is set now to evaluate and buy on the cheap damaged debt that has clogged the credit markets ever since the mortgage debacle created chaos.

LUK's month pales next to our **Ford Convertible Cumulative Preferred**. It rose 123.2%, and does not take into account the quarterly dividend, the decision to defer payment of which marked the low point for the shares at \$3 back in early March. As the shares tumbled earlier this year, we wondered in those

quiet moments before dawn, whether we had missed something crucial in continuing to recommend it even as it dropped inexorably. At its \$3 intraday low, the "dividend," which the market obviously felt would never

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be brought current, stood at 108%, enough to scare off even the most intrepid buyers. For any fool that treads where angels reasonably would fear to go, the results have been, for want of a better word, miraculous. Since then, Ford has emerged as the most likely American car company to survive and do that without a federal bailout. We readily concede that everything is relative. For instance, Ford's quarterly results, which on the day they were announced drove the common up 11.4% and the preferred 14.2%, featured a \$1.4 billion loss, much less than Wall Street had expected. Around that time, Goldman Sachs added Ford to its Conviction List.

Though there is a limit for the price of Ford shares, we suspect that when auto sales improve here at home and abroad, Ford preferred at \$21.07, its price as we close this month's issue, will be thought a bargain. Note that the premium investors are willing to pay for the preferred keeps moving higher above the value of the 2.8249 shares of Ford common into which it can be converted. At today's close, the premium stands at 19.6%. The yield now has dropped to 15.4%.

REITs have also had a field day since investors stopped expecting Armageddon. **HRPT**, which last week reported solid results for the quarter, has added 30.1% including its dividend. It's no surprise that occupancy slipped but only modestly to 89.5% from

## Sound Advice Portfolio for May 2009

| Income With Growth                  | Symbol  | Exchange/ Phone | Price/<br>N.A.V.* | Yield**   | Buy Limit      | ACTION |
|-------------------------------------|---------|-----------------|-------------------|-----------|----------------|--------|
| Duke Realty Cumulative Preferred    | DRE.PRO | NYSE            | \$17.70           | 11.83%    | <b>\$20.00</b> | BUY    |
| HRPT Properties                     | HRP     | NYSE            | \$4.77            | 10.06%    | <b>\$5.25</b>  | BUY    |
| Public Storage Cumulative Preferred | PSA.PRM | NYSE            | \$19.44           | 8.52%     | <b>\$21.00</b> | BUY    |
| <b>Diversified Growth</b>           |         |                 |                   |           |                |        |
| Agrium                              | AGU     | NYSE/TSE        | \$45.20           | 0.24%     | <b>\$50.00</b> | BUY    |
| Boston Scientific                   | BSX     | NYSE            | \$9.31            | 0.00%     | \$11.00        | BUY    |
| CarMax                              | KMX     | NYSE            | \$12.58           | 0.00%     | \$14.00        | BUY    |
| CGM Realty Fund                     | CGMRX   | 800-343-5678    | \$15.58           | 3.92%     | N/A            | BUY    |
| Dodge & Cox Intl.Fund               | DODFX   | 800-621-3979    | \$24.94           | 9.03%     | N/A            | BUY    |
| Dodge & Cox Stock Fund              | DODGX   | 800-621-3979    | \$78.94           | 2.33%     | N/A            | BUY    |
| Fastenal                            | FAST    | NASDAQ          | \$36.62           | 1.91%     | \$41.00        | BUY    |
| Gabelli Global Telecom              | GABTX   | 800-422-3554    | \$15.60           | 2.12%     | N/A            | BUY    |
| Honeywell                           | HON     | NYSE            | \$34.72           | 3.49%     | \$38.00        | BUY    |
| Johnson & Johnson                   | JNJ     | NYSE            | \$54.98           | 3.35%     | \$68.00        | BUY    |
| Leucadia National Corp.             | LUK     | NYSE            | \$25.22           | 0.00%     | <b>\$32.00</b> | BUY    |
| Mattel                              | MAT     | NYSE            | \$15.52           | 4.83%     | \$18.00        | BUY    |
| Microsoft                           | MSFT    | NASDAQ          | \$19.42           | 2.68%     | \$26.00        | BUY    |
| Molson Coors Brewing                | TAP     | NYSE            | \$42.00           | 1.90%     | \$45.00        | BUY    |
| Odyssey Healthcare                  | ODSY    | NASDAQ          | \$10.72           | 0.00%     | \$12.75        | BUY    |
| Sprint Nextel                       | S       | NYSE            | \$5.24            | 0.00%     | <b>\$6.00</b>  | BUY    |
| Stryker Corp.                       | SYK     | NYSE            | \$41.55           | 0.96%     | <b>\$45.00</b> | BUY    |
| Superior Industries                 | SUP     | NYSE            | \$15.00           | 4.27%     | <b>\$18.00</b> | BUY    |
| Tetra Tech                          | TTEK    | NASDAQ          | \$24.96           | 0.00%     | \$28.00        | BUY    |
| Third Avenue Value Fund             | TAVFX   | 800-443-1021    | \$38.50           | 0.48%     | N/A            | BUY    |
| United Parcel                       | UPS     | NYSE            | \$57.62           | 3.12%     | <b>\$60.00</b> | BUY    |
| UnitedHealth Group                  | UNH     | NYSE            | \$28.87           | 0.10%     | <b>\$35.00</b> | BUY    |
| Wal-Mart Stores                     | WMT     | NYSE            | \$50.14           | 2.18%     | \$60.00        | BUY    |
| WisdomTree Dividend Top 100 Fd      | DTN     | NYSE            | \$33.36           | 6.39%     | N/A            | BUY    |
| Xerox                               | XRX     | NYSE            | \$6.69            | 2.57%     | <b>\$8.00</b>  | BUY    |
| <b>Energy/Natural Resources</b>     |         |                 |                   |           |                |        |
| Anglo-American PLC                  | AAUK    | NASDAQ          | \$12.50           | 0.00%     | <b>\$15.00</b> | BUY    |
| Icon Energy Fund                    | ICENX   | 800-764-0442    | \$15.44           | 0.75%     | N/A            | BUY    |
| Plum Creek Timber                   | PCL     | NYSE            | \$35.20           | 4.77%     | <b>\$40.00</b> | BUY    |
| PowerShares Water Resources ETF     | PHO     | NYSE            | \$14.68           | 0.54%     | <b>\$17.00</b> | BUY    |
| Transocean                          | RIG     | NYSE            | \$75.42           | 0.00%     | <b>\$85.00</b> | BUY    |
| USAA Precious Metals & Minerals     | USAGX   | 800-862-6909    | \$25.19           | 0.04%     | N/A            | BUY    |
| <b>Aggressive Growth</b>            |         |                 |                   |           |                |        |
| Comcast                             | CMCSA   | NASDAQ          | \$15.75           | 1.73%     | <b>\$19.00</b> | BUY    |
| Ford Motor Convertible Pfd          | F.PRS   | NYSE            | \$21.09           | 15.41%*** | <b>\$25.00</b> | BUY    |
| Icon Financial Fund                 | ICFSX   | 800-764-0442    | \$4.88            | 0.00%     | N/A            | BUY    |
| Liberty Global                      | LBTYA   | NASDAQ          | \$17.33           | 0.00%     | <b>\$19.00</b> | BUY    |
| Maxim Integrated                    | MXM.PK  | NASDAQ          | \$14.02           | 5.71%     | \$16.00        | BUY    |
| Federated Prudent Bear Fund***      | BEARX   | 800-711-1848    | \$6.38            | 0.00%     | N/A            | BUY    |
| Symantec                            | SYMC    | NASDAQ          | \$14.88           | 0.00%     | \$19.00        | BUY    |
| Time Warner                         | TWX     | NYSE            | \$25.20           | 0.87%     | <b>\$28.00</b> | BUY    |
| Western Digital                     | WDC     | NYSE            | \$23.71           | 0.00%     | \$26.00        | BUY    |

\*Prices as of the market close on Friday, May 8, 2009

\*\*Yield represents all income during previous 12 months divided by current share price.

Note that all fund distributions fluctuate annually.

\*\*\*Dividend Deferred

**BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT**

## Sound Advice: Portfolio Updates for May 2009

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91.4%. Income rose about 8% primarily due to opportunistic acquisitions made in the depressed commercial real estate market during 2008 and 2009. Expect more of the same on top of the four more buildings bought last quarter with a cap rate of 11%, which means hefty cash flow. Management also bought back about 2% of outstanding common shares at an average cost of \$3.57 per share (HRP closed today at \$4.77).

Our two REIT preferreds also performed admirably. The **Duke Realty Preferred (O Series)** added 39.8%. Two months ago, when we priced the March portfolio, this issue was \$7.25. As with HRPT, Duke's quarterly returns allayed any concerns that this REIT was headed for trouble. The name of the game has been to shore up balance sheets, make sure any refinancing of existing debt could be handled and to be on the lookout for buys from distressed sellers.

**Public Storage Preferred (M Series)** added 5.9%. Why did it lag the Duke preferred? PSA, as noted in the original recommendation, has the best balance sheet in all of REITdom, because it has trivial debt requiring refinancing. PSA's funding strategy is to use an alphabet-long series of preferreds to generate cash for expansion. Hence, the risk premium for its preferreds has always been low. It remains attractive for investors who don't want surprises. Finally, **CGM Realty Fund** is up 19.8%. Next issue, we should have data on how the mercurial Ken Heebner, who manages the fund, has realigned his ever-changing portfolio.

We could continue reeling off the rest of the 24 double-digit gainers, but instead it's instructive to look at what lost ground since the last issue. It's obvious that the **Prudent Bear Fund** would drop in a fast-rising market, but the loss was a relatively minor 5.5%, which we attribute to how its long positions in precious metals buffered its shorts. Our own holding, the **USAA Precious Metals & Minerals Fund**, added 9.5%. **Symantec** lost 8.3% (see page 5) and **Wal-Mart** 6.8%. WMT's weak performance mostly shows how investors are moving away from safe harbor companies that fare well in a weak economy and toward greater risk in those that do better during periods of growth. **Fastenal** slipped 1%. We're seeing similar weakness in Treasury Notes. The yield for the bellwether 10-Year, for instance, has risen to 3.3% and fallen in price. When we priced the April issue, the yield was 2.9%.

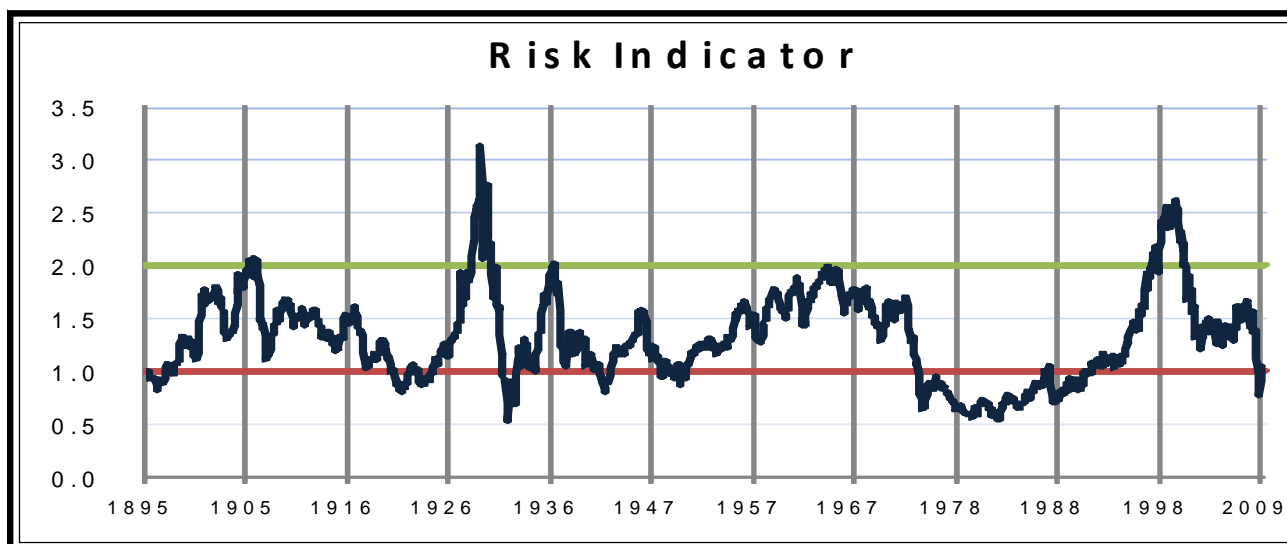
In bond-land that is a huge swing, and suggests that money is coming out of ultra-safe Treasuries in search of greater rewards in essentially more risky equities. One sector that contradicts this flight to risk is healthcare, which you'd expect would struggle as investors' appetite grows for stocks that do best in an expanding economy. Not this month.

**United Healthcare**, the medical insurer, jumped 40.6%. Quarterly numbers beat expectations both for revenue and profits, but what is driving not just UNH but other medical stocks is the dawning realization that the Obama administration looks like it will accept a national insurance program that includes private companies like UNH. We have harped on this theme ever since Obama was elected, but were drowned out by the dread that the new administration was out to dismantle capitalism and remove private companies from providing health insurance.

**Stryker**, which designs and manufactures replacement knees, hips and assorted other body parts as well as operating room and other hospital products tacked on 24.8%, had been clobbered earlier in the quarter after Wall Street convinced itself that demand for orthopedic replacement procedures would dwindle in a recession. Hard news that Stryker had not received FDA approval for a product to bind bone also shook confidence. But then a counter story developed. First, **Johnson & Johnson** (+5.4%) said its own orthopedic division, which competes against Stryker, had a good quarter, which allayed concerns about demand, and then Stryker itself held its quarterly conference call and reinforced that idea. Then the Department of Justice announced it had dropped criminal charges against four other device companies stemming from charges that they had enticed orthopedic surgeons and hospitals to use their equipment. Stryker had never been under indictment, and had cooperated with the DOJ. There is also a growing sense that Congress won't impose draconian reimbursement rules. **Boston Scientific**, the stent and pacemaker manufacturer, added 11%.

Not to sound like a broken record, it's hard to believe that the market can continue the past two months' dazzling results. It's likely that prices will drop as investors take short-term profits. However, we recommend not trying to dart in and out among ever-changing prices. Hold on and, if prices for something you like fall, seize the opportunity. **SA**

# Sound Advice Market Indicators for May 2009



The Risk Indicator measures the overall risk in the stock market by plotting the ratio of stock prices to home prices. See *The Science of Making Money in Turbulent Stock Markets* for a full explanation of the Risk Indicator and the Diffusion Indexes.

The Risk Indicator was 1.06 in April. A reading this low reveals that stocks are historically low relative to house prices, and present an extraordinary value. February's reading of 0.79 will likely market the low for this cycle.

**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. This Diffusion Index currently stands at 17 percent.

**The Diffusion Index of Leading Indicators** gives "Aggressive" signals when all four of its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

## A New "Aggressive" Signal

Until now, we were operating under a "Caution" signal. Last month, we projected that when the March data is released in April, the Diffusion Index would drop to zero. Indeed, the latest data for

March brought this Diffusion Index to zero, officially giving us an "Aggressive" signal.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. See *The Science of Making Money in Turbulent Markets* for a history of Supercycles (which you received with your subscription). You will also receive an updated copy when you renew your subscription.

## Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual return of 25.8. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent.

| Aggressive S&P | Caution S&P |
|----------------|-------------|
| Sep-74         | 68.12       |
| Nov-79         | 100.00      |
| Dec-84         | 164.48      |
| Jul-86         | 240.18      |
| Mar-88         | 265.74      |
| Mar-89         | 280.00      |
| Oct-89         | 347.40      |
| Feb-97         | 798.38      |
| Oct-00         | 1,429.40    |
| Jun-03         | 974.50      |
| Jul-06         | 1,276.66    |
| Apr-09         | 865.33      |

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