



-Gray Emerson Cardiff

How High is Too High?

That is the age-old question. As bull markets rise year after year, the natural tendency is to believe that a rising market is the natural state. Even looking over the history of the market, it indeed tends to rise over the longer term. However, we all know that the market eventually gets “too high”, and a serious correction ensues.

These corrections are very important because they erase many years of growth in our portfolios. For example, a fifty percent drop takes a 100 percent recovery, which normally takes many years, just to break even. If the drop was avoided, the 100 percent increase would double our investment capital rather than just recovering. With this in mind, it becomes evident that

it is worth missing the frothy end of bull markets if it means avoiding the crashes.

A good example is our own experience beginning in the late 1990s. Our value-oriented approach made it very difficult to participate in the high-tech stock boom of in the late 1990s when price earnings multiples expanded to historic highs, even to infinity in many cases when actual earnings from most start-ups were not even on the horizon. Instead, we were recommending boring REITs that were trading at very attractive valuations. We missed the frothy profits at the top of the bull market. However, investors who rode the froth over the crest and into the abyss, which was the majority, were crushed. From the peak of the market at the beginning of 2000, through the end of 2002, the S&P 500 dropped 46.5 percent. The drop in NASDAQ, which was comprised of more tech start-ups, dropped even more. By contrast, the *Sound Advice* model portfolio actually increased 55.8 percent during the same period.

Our Risk Indicator (page 10) was useful back then. This indicator rocketed above 2.0 in 1999, warning us that the market was simply too high. Our Risk Indicator is based on the ratio of the stock market prices and real estate prices. As we have documented in *The Science of Making Money in Turbulent Markets*, the ratio of these two fiercely competitive markets reveals when one of these markets becomes super-heated relative to the other. When the ratio rises above 2.0 stocks are dangerously high. By contrast, a reading below 1.0 tells us that stocks are historically low. During the last 100+ years, our Risk Indicator had provided 39.7 times more profits than a simple buy and hold strategy. Currently our Risk Indicator is 1.68, which tells us that stock prices are above average relative to house prices, but not “too high”.

As we all know, no indicator is perfect, and it is important to know when it may not be doing its job. The problem with our Risk Indicator comes when both markets become super-heated, which was the case prior to the 2008-09 crash. As both stock prices and house prices climbed, the ratio did not rise above the danger zone of 2.0. This one-time exception is why our Risk Indicator is not perfect, and once is enough reason not to rely exclusively on any single indicator. Since the 2008-09 melt-down, both stock and house prices have been rising, so the same problem could be arising again.

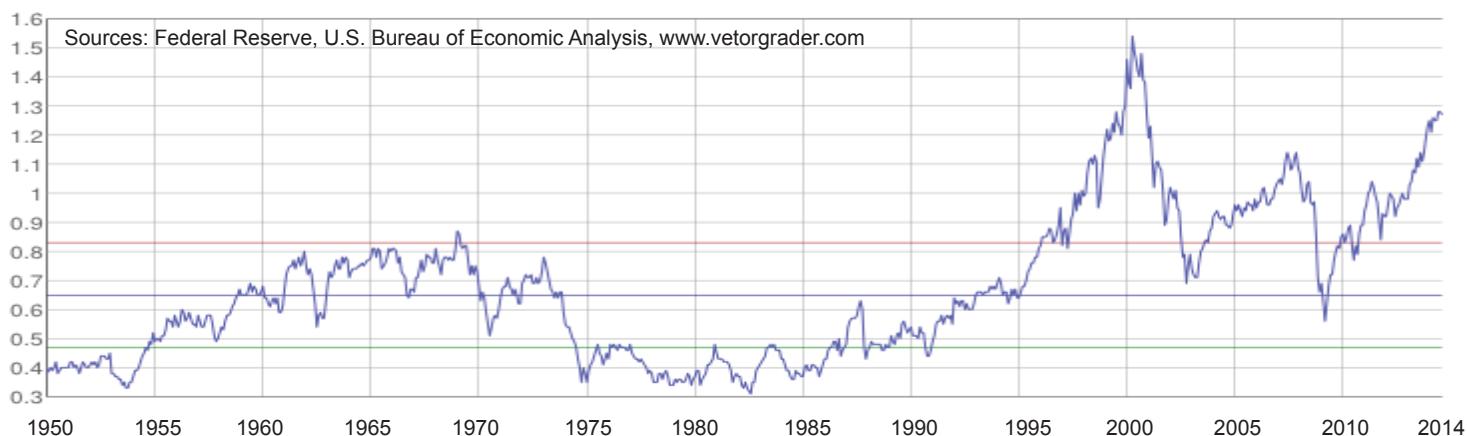
Buffet's Best Indicator

According to Warren Buffet, “probably the best single measure of where valuations stand at any given moment” is the ratio of the total capitalization of the stock market (stock prices of all publically traded companies multiplied by their respective amounts of shares outstanding) divided by the gross domestic product (GDP) of the US. When this ratio is high, stock prices are also dangerously high.

The current ratio is 1.27. Notably, this ratio rose above 1.2 in the late 1990s prior to the 2000-02 bear market that took stocks down nearly 50 percent. This ratio also rose above 1.1 just prior to the 2008-09 bear market which took stocks down nearly 50 percent again. According to this indicator, stock prices are currently dangerously high.

A chart of this ratio follows on the next page.

Total Stock Market Capitalization versus the US GDP



With the total market capitalization alarmingly high, why not sell everything? The simple answer is because interest rates are still historically low in the US and around the world. As we all know, low interest rates are bullish for stocks.

For the time being, the Federal Reserve is continuing to hold down short-term interest rates, and inflation is still below the Fed's target of 2.0 percent, thanks primarily to declining energy prices.

A few days ago, the Bank of Japan (BOJ), the counterpart to our Federal Reserve, announced that it will boost its quantitative easing (QE) program by purchasing its sovereign bonds to the tune of 15 percent of its GDP annually. On a relative basis, this new asset purchase program is substantially greater than the Federal Reserve's QE programs, and greater than any attempted by other major central banks.

The Japanese move puts new pressure on the European Central Bank (ECB) to step up its stimulus efforts. China may also follow with stimulus of its own.

As long as world interest rates remain low, the backdrop is bullish for stocks. Of course, this is not a permanent situation. Eventually, stimulus leads to economic vitality, which in turn, leads to rising interest rates. At that point, stocks will be too high.

Portfolio Updates

We continue to operate under the caution signal given by our Diffusion Index of Lagging Indicators (page 11). That means we have positioned the *Sound Advice* portfolio for an improving US economy and the increasing inflationary pressures and rising interest rates that an economic expansion ultimately fuels.

Our REITs and real estate stocks and funds have been steady performers and are bound to be net beneficiaries as the US economy continues to grow. When interest rates start pushing up mortgage rates, it will be as a result of an expanding economy and the corresponding increases in rental rates that normally more than compensate. These,

along with our other hard-asset stocks and funds, should also benefit from rising inflationary pressures.

Although energy stocks and mutual funds have been languishing under soft oil prices, ultimately they are bound to bring attractive profits because energy is woven into the fabric of the economy and subject to worldwide demand.

When stock prices are generally high, it is exceedingly important to emphasize value, and our value-oriented approach should continue to pay off.

Here are updates on the individual positions of our portfolio, in alphabetical order.

Agrium (AGU) is up 9 percent this year, extending our profit to 611 percent. AGU has a broad mix of agricultural products and services that are poised to benefit from growing demand as arable land continues to disappear around the world and the need for higher food production per acre increases. Growth is also bolstered by an expanding worldwide population along with increasing per-capita income.

It looks like the activists are at it again, this time it is ValueAct Capital, a San Francisco-based hedge fund manager, which recently acquired 5.7% of AGU. ValueAct has not declared its intentions publicly, but it has stated it will work with management or the board to implement strategies to optimize shareholder value.

These are the words JANA Partners used at the beginning of what ended up in a full proxy battle. JANA's attempt at various proposed actions was aimed at increasing shareholder value by \$50 per share. JANA's primary contention was that Agrium's retail business would attract a higher valuation as a separate company than under the current conglomerate structure. In addition, JANA thought the separation would reduce costs substantially. JANA lost the proxy battle because the management argued that the company as a whole had been growing so well during the prior 10 years.

In recent years, however, the fertilizer side of the business has been sputtering under sinking fertilizer prices and increased world-wide competition, so management will not

have the same argument this time.

Attention from activists are generally positive for stock holders. JANA's proxy battle caused AGU to climb from \$80 to \$115. This time, AGU jumped 8 percent on the day ValueAct announced its acquisition of Agrium stock. In any case, the weeks ahead should be positive. This is also confirmation that others also think that AGU is an under-valued stock.

Associated Estates Realty Corp (AEC) is up 26 percent so far this year, extending our gain to 46 percent. What originally attracted us to AEC was the fact that this high-quality apartment REIT was selling at a substantial discount to the value of its net assets.

Although AEC has since risen in price, so has the value of its real estate portfolio. In the final days of October, AEC reported its third quarter results. Based on these results, we value the equity of AEC's apartment portfolio at \$28.5 per share, still considerably greater than the current stock price. During the third quarter, the net operating income on the properties owned for the last 12 months increased 2.7 percent, and occupancy ended the quarter at 95.6 percent.

In September, AEC raised its annual dividend to \$0.80 per share. It remains a stellar value with a nice dividend.

Boston Scientific (BSX) is up 10.5 percent so far this year, extending our profit to 40 percent. BSX's medical products are well suited for an aging population in the US. 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.

At the end of October, BSX reported robust results, with revenue up 6.4 percent from one year ago, which translated into a stunning 960 percent increase in earnings. Also encouraging was the fact that revenue grew across all 7 of the company's business sectors, and future guidance from the company remains positive.

During the quarter, BSX continued to launch innovative and competitive products and received more favorable recommendations from the FDA on some of its most significant cardiovascular products, including its appendage closure device WATCHMAN. BSX also completed its first commercial cases of its cardiac mapping catheter and navigation system. During the quarter, BSX completed its acquisition of the Interventional Division of Bayer AG which will increase penetration into the pharmaceutical industry.

Chesapeake Energy (CHK) is down 17 percent this year, trimming our gain to 37 percent. CHK is the second largest producer of natural gas and pioneered the use of fracking technology, a process of pumping liquids into shale under high pressure to recover oil liquids and natural gas that would not otherwise be recoverable. We added CHK to the portfolio because it was at a substantial discount to its net assets. The stock price was cheap because of low natural gas prices, poor corporate governance, and because it was

in the midst of a financial squeeze. We could see all of these conditions were likely to be remedied, and indeed they were. Natural gas prices have recovered, the company has new leadership, and billions of assets have been sold to remedy the financial problems.

In October, CHK announced the sale of its non-core acreage in the Marcellus and Utica shale in West Virginia and southern Pennsylvania for \$5.375 billion. The stock responded positively on the news because the sale bolsters CHK's balance sheet and gives the company a cash hoard to enhance shareholder value through acquisitions and developing its liquids-rich core assets at a faster pace, especially in the Niobrara and Eagle Ford.

At close to 10 times projected 2015 earnings of \$2.30, CHK is a good value. Morningstar's \$37 fair value estimate of CHK is confirmation of the value we see at the current stock price.

Fidelity Select Natural Gas Fund (FSNGX) is down 3.3 percent this year, trimming our gain to 26 percent.

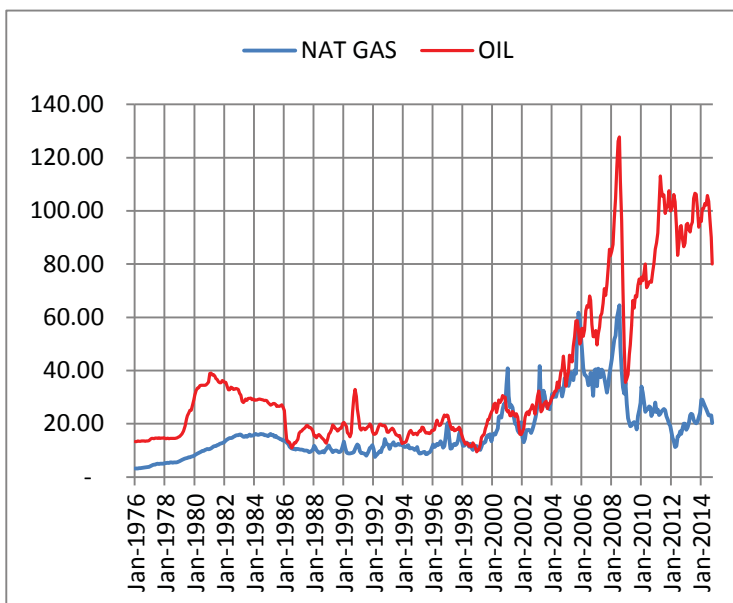
Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other sources of energy, which translates into an inexorably vibrant and expanding natural gas industry.

One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. With one barrel of oil at \$100, that is the cost of 5.8 million BTUs of energy. On the other hand, with a market price for natural gas at \$4.00 for one million BTUs, 5.8 million BTUs will cost \$23.20 (5.8x\$4). So the same amount of energy is available for 23 cents on the dollar -- if it is in the form of natural gas.

To illustrate the point, we continue to display the historic relationship between the costs of these two forms of energy in the chart below because it demonstrates that today's disparity is not a normal situation.

The red line shows the price of a barrel of oil since the

The Cost of Energy Equivalents of Oil and Natural Gas



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. Note that for most of the time that the two forms of energy are closely aligned.

Freeport-McMoRan Copper & Gold (FCX) was originally added to the portfolio last year at \$30.42 per share.

Copper is woven into the fabric of every developed economy, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. In March 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. As the world's economies continued to expand into 2008, so did FCX.

Since the Phelps Dodge transaction, FCX has added substantially to its copper reserves and continues to have opportunities to add reserves because of its large resource base and ongoing exploration program.

The 2013 acquisition of substantial oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico is an added bonus both for earnings growth and stability.

Prices of FCX's primary assets, copper, energy, and to some extent gold, have been soft recently amidst slow economic growth outside the US. However, this condition is not a permanent situation. FCX offers a very attractive dividend yield with excellent long-term growth potential.

Hambrecht & Quist Life Sciences Fund (HQL) is up 24 percent this year, extending our profit to 77 percent. HQL is a closed-end fund which means that the price of the fund can vary from the value of the underlying net asset value (NAV) of the fund's holdings. Currently the price of HQL is close to a 5 percent discount to its NAV.

This Fund 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. The biotech sector is projected to exceed the earnings of nearly all other sectors of the economy.

Gilead Sciences, HQL's largest holding, is the inventor of *Sovaldi*, a drug that cures Hepatitis C, and promises to be the most successful drug ever. Gilead also has promising remedies for HIV and AIDS, along with products for cardiovascular needs, macular degeneration, cystic fibrosis, and influenza.

Substantial HQL's also holds a variety of biotechs, all

of which have promising products and treatments for a wide variety of dreaded diseases. These include Celgene, Biomarin Pharmaceuticals, Pharmacyclic, Biogen Idec, Medivation, Amgen, Regeneron Pharmaceutical, Puma Biotechnology, and Sangamo BioSciences.

Hersha Hospitality (HT) is up 35 percent since our recommendation in December 2013. Our principal reason for recommending HT was because the stock was selling at a significant discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the economic recovery.

In addition, 70 percent of its major properties were undergoing renovations, and were not producing their full income potential. HT was also in the process of selling its sub-par non-core properties in order to deploy assets into more productive properties. HT reported third quarter results at the end of October. Revenues per room (RevPAR) were up strongly in all geographic areas: 17.7 percent in Boston, 15.4 percent on the west coast, and 9.5 percent in Manhattan. This was the first quarter that the company saw the early benefits of completed renovation and development projects.

Based on the most recent quarterly results, we value HT's NAV at \$7.49 per share. However, increases in the NAV valuation are bound to occur as income from new acquisitions are realized along with increased income from completed renovations.

In September, as a result of the cash flow growth so far from the ramp-up of strategic acquisitions and renovations, Hersha increased its quarterly dividend from \$0.06 per share to \$0.07 per share.

HT has an excellent risk/reward ratio. Risk is minimized with the stock below a currently depressed net asset value. The dividend is solid because it is well-covered by funds from operations (FFO). The yield is attractive and limits downside movement in the stock price.

ICON Energy Fund Class S (ICENX) is up 1.8 percent since we added it to the portfolio last year. We added this fund to the portfolio because it takes energy to make everything, and especially large amounts to make the most vital materials and substances, such as chemicals, plastics, and to run data centers. The best time to invest is when demand is down, when the world economy is in a slump, or there is a temporary glut, both of which have added up to a 20+ percent decline in oil prices recently. Aside from the cyclical timing, above average investment returns can be earned over the long run. Over the last 10 years, the Energy

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Equity Index has produced superior investment returns to that of the S&P 500. That performance is because energy is in the fabric of the economy.

Most energy mutual funds have not been able to match the performance of the Energy Equity Index. However, this fund has out-performed the Energy Equity Index resoundingly.

Seven industries make up the sector (as represented by the S&P 1500 Energy Index): integrated oil and gas, drilling, equipment and services, exploration and production, refining and marketing, storage and transportation, and coal and consumable fuels. ICON management looks for changes within these sectors to capture value, rather than simply depending on rising prices. This fund has achieved growth even during periods of declining energy prices. The track record of this fund bears this out. The changing landscape should provide opportunities ahead to capture values.

NCR Corp (NCR), formerly known as National Cash Register, 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. A catalyst for growth comes from the fact that approximately 90 percent of ATMs in the US still run on Windows XP which Microsoft just stopped supporting. That will translate into increased demand for NCR's ATMs.

NCR is cheap because rapid earnings growth came to a halt in 2013, causing the stock to slide. The reason for the slowdown in earnings was because NCR increased its debt load to make two significant purchases -- Retailix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth. However, these acquisitions have started to add to earnings and have pushed NCR much farther along its path from a hardware provider to more of a software and services provider where profit margins are substantially higher.

In October, NCR announced third quarter earnings. Although revenue was up 8 percent year over year, earnings were \$0.04 below expectations of \$0.71. The company lowered its guidance regarding full year 2014 earnings expectations to the range of \$2.60 to \$2.70, down from previous expectations of approximately \$3.00. The stock dropped from just under \$30 to below \$24 on the news. We said in our blog that the drop appeared to be a classic overreaction and a buying opportunity.

The reason given for the reduced guidance was perceived weakness in the retail sector which will cause delays in the introduction of large software products. However, these products are still on the shelf and are likely to be introduced next year.

What the overreaction is overlooking is the stellar rise in revenue from the financial services, which is nearly double the size of the retail sector, and evidences the beginning of benefits from the Digital Insight purchase.

Although the stock has since recovered from its recent drop, it is still close to 10 times the reduced guidance for 2014 earnings, which is a steep discount to the market and its peers.

No-Brainer ETFs: We have covered the inevitability of rising bond yields with ETFs designed to benefit from rising long-term Treasury bond yields. They differ in the amount of leverage used:

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.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance.

We have dubbed these ETFs as "No-Brainers" because interest rates always rise after a recession during the recovery. The upward path has never been smooth, and this time is proving to be no exception.

Although the US economic continues to exhibit strength, the Federal Reserve has been keeping interest low because US inflation is at bay, due mainly to the decline in energy prices. Slow economic growth elsewhere, especially in Europe, has also been a headwind on interest rates. However, low interest rates and energy prices will stimulate growth there, just as they do here. New stimulus programs are also bound to pep up growth. As economies around the industrialized world exhibit more vitality, along with mounting strength in the US economy, pressure will mount on the Federal Reserve to let US interest rates rise to normal levels, from the emergency levels established 5+ years ago to bail us out of the 2008-09 melt-down.

The Fed is now officially done with its massive quantitative easing (QE) Treasury bond-buying program, clearing the way for the normal forces of supply and demand to take over. With Treasury bond yields at historic lows, they can only go up from here.

As far as the timing is concerned, the best forecast we have to go on is that of the Federal Reserve itself. The Federal Reserve's official forecast projects the benchmark Federal Funds rate will increase from zero currently to 1.2% by the end of 2015 and to 2.5% by the end of 2016. Beyond that, officials project that the Federal Funds rate could settle in at 3.75%.

To reach 1.2 percent by the end of 2015, the Federal Funds rate will need to start increasing from its current rate of zero by the end of January, 2015, and increase an average of 0.0050 percentage points (0.5 basis points) during each trading day. Continuing those daily increases during 2016 brings the Federal Funds rate to the Federal Reserve's target of 2.5 percent.

At the very least, Treasury bond yields should move in

tandem with the Federal Funds rate. That means long-term Treasury bond yields will rise from 3.07 percent today to 4.27 percent by the end of 2015, and to 5.57 percent by the end of 2016.

We can construct a model of these ETFs based on the Federal Reserve's forecast. 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 with an average maturity length of close to 27 years. The prices of our No-Brainer 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.

If we assume that the ascent in interest rates will not begin until the end of January in accordance with the Federal Reserve's forecast, we may see these ETFs erode until then. As we have illustrated in prior issues, there is an erosion factor with these ETFs because they decline slightly more on downswings than they rise on equivalent upswings in bond yields, and the erosion factor is more pronounced with leverage. With bond yields at absurdly low levels, there is not much room for declines, but they could churn up and down, rising say, 5 basis points one day and declining the same amount the next. Based on history, this would be a high degree of churning and it would be unusually detrimental.

This churning would erode TMV's price the most, by 2.5 percent, because it uses the most leverage. TBT would erode 1.2 percent, and TBF would erode 0.35 percent. Then, this erosion would be followed by steady price increases in all three ETFs, along with rising interest rates.

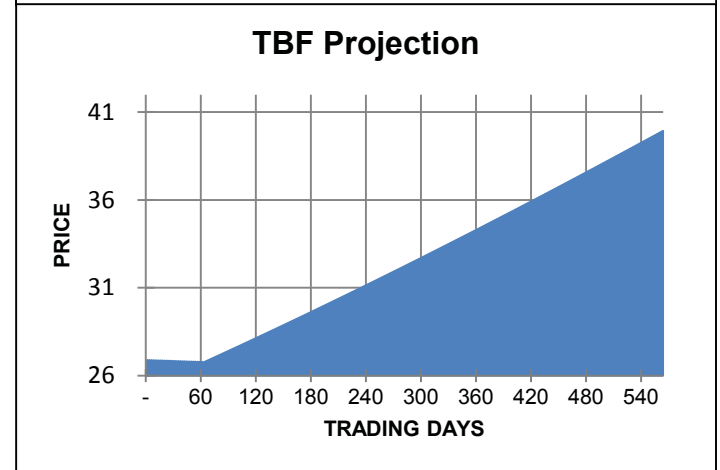
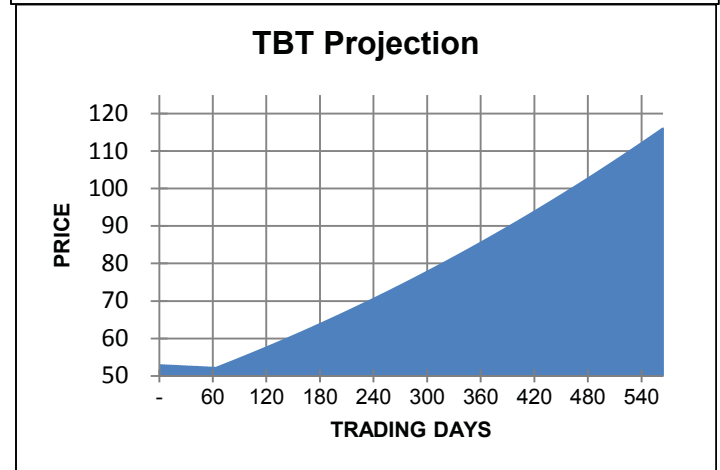
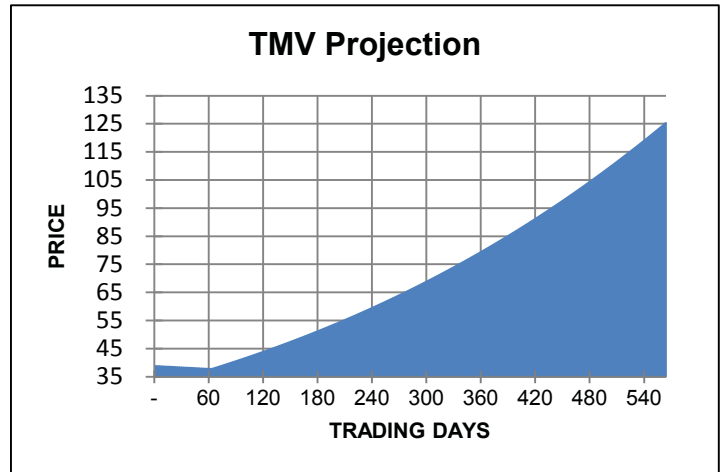
TMV would rise to \$125 by the end of 2016, slightly more than three times its current price. The chart to the right shows the pattern, including the erosion until January.

TBT would rise to \$116 by the end of 2016, slightly more than twice its current price. The chart to the right shows the pattern.

TBF would rise to \$40 by the end of 2016, which is 48 percent greater than its current price. The chart to the right shows the pattern.

While these ETFs are no-brainers after a recession because interest rates always rise, the ride has been rougher than we first anticipated. However, even though the Federal Reserve's forecast calls for a gentle increase over a long period, it would still push up the prices of these ETFs substantially, and demonstrates the profit potential.

We should also keep in mind that the Federal Reserve projects the "normal" Federal Funds rate to "settle in at 3.75%." That brings long-term Treasury bond yields to 6.82 percent assuming a tandem rise with the Federal Funds rate, and potentially larger profits for these ETFs. At any rate, we



continue to believe it is bound to be worth the ride.

Pfizer (PFE) is essentially unchanged this year, leaving our profit at 94 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on its blockbuster drug, *Lipitor*. However, its future was brighter due to the arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage. Among the most significant include *palbociclib* for advanced breast cancer, a meningitis B vaccine, and *Xeljanz* for inhibiting the progression of rheumatoid arthritis. Pfizer's top selling drugs include *Lyrica* (for pain and fibromyalgia), and *Pprevnar* vaccines (for

pneumonia and other infections).

In late October, PFE reported earnings of \$0.57 per share, which was \$0.01 less than the same quarter one year ago but higher than the expectation of \$0.55 per share.

The strongest quarterly revenues came from oncology and vaccines. The 17 percent increase in oncology was led by PFE's drugs *Xalkori* and *Inlyta*, and vaccine sales were higher by 19 percent led by its *Pprevnar* vaccines.

Revenues from PFE's best-selling nerve pain drug, *Lyrica*, grew by a stunning 16 percent and on track to be a blockbuster bringing in \$5 billion annually. PFE's most promising prospect is its breast cancer drug *palbociclib* which if used in concert with Novartis' drug *Femara* nearly doubles progression-free survival to 20 months.

Pfizer has repurchased \$4.2 billion of its own common stock during the first 3 quarters of 2014, and is on track to purchase \$5 billion in 2014.

PFE is a good value with promising growth from a wide array of drugs and treatments. Its dividend is close to 3.5 percent.

Retail Opportunities Investment Corp (ROIC) is up 14 percent this year, extending our profit to 65 percent. This REIT 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.

In October, ROIC reported operating income of \$12.3 million for the third quarter, nearly double the \$6.5 million during the same quarter last year. Demand continued strong for ROIC's space. The quarter ended with occupancy at 97.4 percent with same-space rents 31 percent higher on new leases.

This REIT is on track with having another record year after purchasing close to \$500 million of grocery-anchored shopping centers during the first nine months of 2014 and has a pipeline of further acquisitions. All of the outstanding stock warrants have been retired which simplifies the financial condition and the relatively conservative balance sheet.

As new properties are added, along with tenant upgrades, FFO is bound to continue to rise, along with the dividend, and push the price of this REIT upward. Meanwhile, ROIC pays an attractive dividend that lowers its risk profile.

Stryker (SYK) is up 17 percent this year, extending our profit to 116 percent. SYK is best known for its orthopedic devices for artificial knees and hips. SYK also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase, and obesity trends continue, more and more hip, knee, and spinal procedures will be needed.

Stryker's cash-rich balance sheet along with its strong cash flow, gives SYK multiple avenues for continued diversified growth through acquisitions, including Small Bone Innovations (SBI) which has products for trauma and diseases in small bones and joints including ankles, fingers, wrists, and elbows; Pivot Medical which has a platform of arthroscopic implants to efficiently access the hip with minimal incision; Berchtold Holding which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems; and the MAKO Surgical acquisition put SYK in a leading position for robotic-assisted surgery and the potential for break-through innovations. The 2013 purchase of Trauson Products, China's largest manufacturer of orthopedic implants, also offers access to the Chinese market and broadens SYK's customer base.

In mid-October, SYK reported a 10.3 percent increase in net earnings, excluding special charges in connection with launching European regional headquarters and planned cash repatriation. Both revenues and earnings were ahead of expectations and the stock has since advanced.

Symantec (SYMC) is up 7.2 percent this year, extending our profit to 53 percent. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. Ninety-nine percent of Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In October, Symantec announced that it will spin off its relatively small storage business as a tax-free distribution of a new publicly traded stock to SYMC shareholders. SYMC has responded positively to the announcement.

The spin-off reverses the acquisition of Veritas ten years ago, a storage company that has proven not to be a drag on growth and not synergistic with the rest of the company. This split will allow both companies to be more competitive and responsive to their respective industries. The storage company is not exciting and in a low-margin, highly competitive industry. Our inclination will likely be to sell it unless the value is compelling. We will keep you advised.

The spin-off will make the balance of SYMC a more attractive acquisition to large I.T. companies because SYMC is currently trading at a low valuation, has a strong balance sheet, and has good cash flows and margins.

Tetra Tech (TTEK) is down 3.7 percent this year, trimming our profit to 70 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet with \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. TTEK also provides energy efficiency and carbon management consulting which are bound to see growth

under the new proposed carbon rules announced by the EPA which are aimed at reducing carbon emissions from power plants by 30 percent by 2030.

In October, TTEK added two new contracts to its backlog, including a \$650 million commitment to improve urban infrastructures in developing countries where more than half of the world’s population lives, and a \$76 million contract to provide technical services to the U.S. Environmental Protection Agency (EPA). This year, TTEK initiated its first quarterly dividend of 7 cents per share for the second quarter and is buying back \$100 million of its common stock.

Third Avenue Funds have a similar approach to ours because management is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value (“NAV”).
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 13.5 percent. It has led the pack of all real estate mutual funds during the last 3 years. This is still where the best real estate values can be found in a mutual fund. It is replete with stellar values substantially below NAV with strong growth prospects.

The **Third Avenue Small-Cap Value Investor Fund (TVSVX)** is unchanged since we introduced it earlier this year. This fund invests in companies with small capitalizations using the same value-oriented approach. Small-cap stocks perform better than large-cap stocks over the longer term 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 profitable. Not only do small caps perform

better over the long run, they generally benefit strongly from a recovering economy.

In making decisions regarding a particular company, management evaluates the entire business enterprise, assesses the assets, and ascertains the NAV. From there, a credit profile is created to ensure that the company has the ability to meet its obligations, take advantage of investment opportunities, and survive financial storms.

Transocean (RIG) was introduced to our portfolio in June because of its low valuation and high yield. It has gone down with the drop in oil prices. While on-land fracking and other new techniques have added to supplies, the majority of oil still comes from deep-water drilling, and RIG is a premier provider of those platforms to the world’s major oil companies.

Although weak oil prices have made it difficult for the drilling industry, RIG has an ace in the hole with its ability to form master limited partnerships (MLPs) to purchase some of its assets and give RIG a cash infusion to bolster its balance sheet. The first MLP was in July, capitalized with \$350 million to purchase a 51% interest in three assets located in the Gulf of Mexico; two ultra-deepwater drill ships which are leased to Chevron and one semi-submersible rig leased to British Petroleum (BP). The next

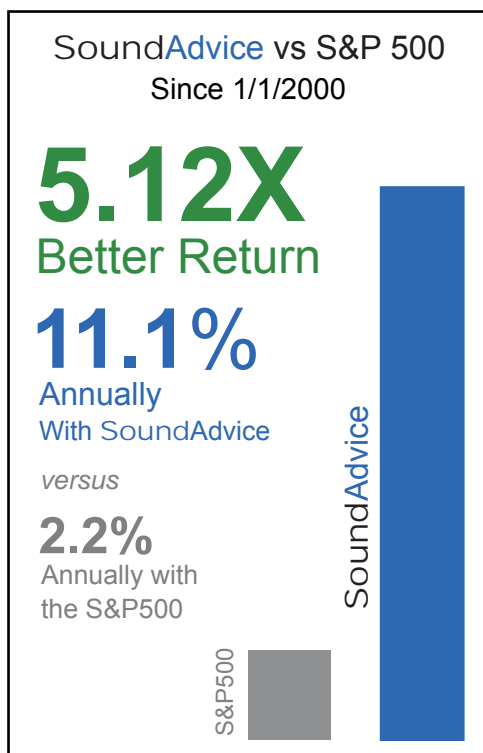
MLP, called the Caledonia Offshore Drilling Company, will purchase 8 of its rigs operating in the North Sea.

The creation of these MLPs is highly beneficial to Transocean because it enables the company to sell assets at higher prices than could be realized in the open market, while still maintaining control of these assets. With the ability to “drop down” assets at retail prices to MLPs, RIG should be able to maintain its dividend which is currently \$3.00 per share. Even forgoing the 15 percent foreign tax (which may be reclaimable on a US tax return) the net dividend is \$2.55 per share for a yield close to 8.5 percent. This yield is too high in today’s market. Once confidence is restored, the stock belongs much higher.

We expect a substantial recovery over the longer run from the current depressed stock price.

USAA Precious Metals & Minerals Fund (USAGX) is down 13 percent this year. When the economic recovery gets more traction, the money created in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities including precious metals.

Geopolitical tensions are a positive for precious metals



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 19.53	3.89%	\$ 20.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 7.29	3.29%	\$ 7.86	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.34	3.67%	\$ 17.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.54	2.09%	\$ 33.00	BUY
Diversified Growth						
NCR Corp	NCR	NYSE	\$ 27.67	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 29.95	3.47%	\$ 32.00	BUY
Stryker Corp.	SYK	NYSE	\$ 87.53	1.21%	\$ 89.00	BUY
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 27.82	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.28	1.88%	\$ 14.50	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE	\$ 97.82	2.61%	\$ 100.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 22.18	1.58%	\$ 25.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 36.47	0.90%	\$ 48.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 28.50	4.39%	\$ 40.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 21.53	3.44%	\$ 27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 26.81	1.04%	\$ 27.50	BUY
Transocean	RIG	NYSE	\$ 29.83	8.55%	\$ 45.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 11.33	0.18%	\$ 18.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 13.28	0.00%	\$ 14.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 38.99	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 26.91	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 52.94	0.00%	\$ 65.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 24.13	0.00%	\$ 25.00	BUY
Symantec	SYMC	NASDAQ	\$ 24.82	2.42%	\$ 25.00	BUY

Notes to the table:

Prices are as of 10/31/2014. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

* Transocean (RIG) and Agrium (AGU) yields are net of the 15 percent foreign withholding tax.

because they are also safe haven assets. This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is the top-performing fund, and has constantly outperformed precious metal equities for ten years.

Xerox (XRX) is up 11 percent this year, extending our profit to 62 percent. We have been recommending XRX because it has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The strongest growth is coming from the expansion into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

In October, XRX reported earnings of \$0.27 per share, narrowly beating expectations of \$0.26 per share. Xerox now expects full-year earnings to be in the range of \$1.11 to \$1.13 per share. At under 12 times earnings, XRX is still cheap.

During the last three years, XRX has repurchased \$816 million of its stock annually. Free cash flow continues to be strong and will be used to continue to buy back more stock in 2014 close to that average. Beyond 2014, XRX plans to repurchase another \$1.0 billion of its stock.

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 underperforming 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 \$11.9 million in stocks and to \$1.52 million in houses.

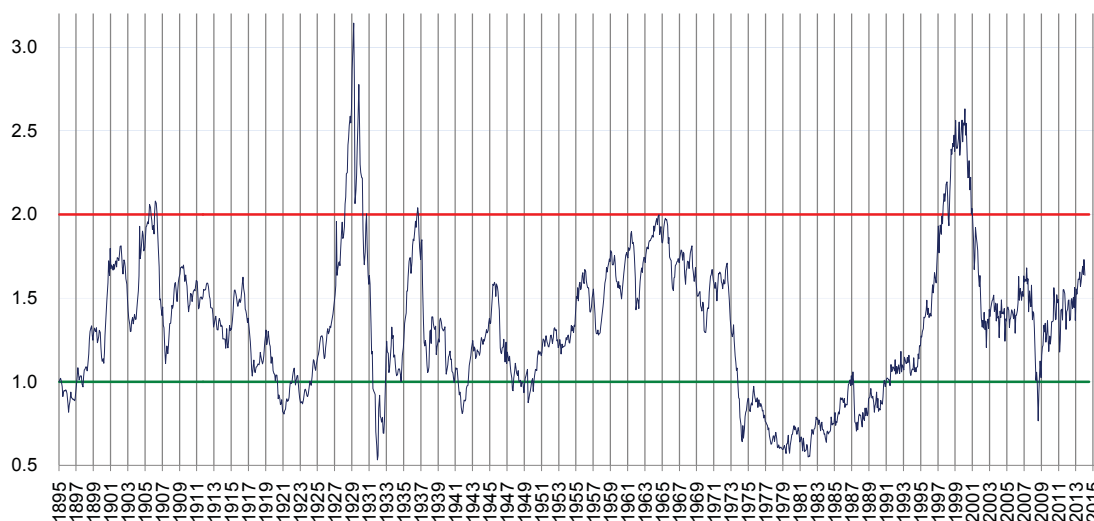
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$471 million, or 39.7 times more money—the 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 Sound Advice Risk Indicator is 1.68. 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 Sound Advice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you re-new 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 economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The SoundAdvice Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 33.3 percent.

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 which reveals that the economy is about to put upward pressures on interest rates, and to move to a cautious approach.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100 percent for the fourth month in a row in June 2014 which tells us that the economy has become strong enough to push up inflation and long-term interest rates along with bond yields. It registered 66.7 percent in September.

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 34.4 percent. During "Caution" signals, the S&P 500 increased an average of 2.4 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
Ave +/-	34.4%		2.4%

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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