

FIVE FOR 2011 RIP



Tony La Russa, the St. Louis Cardinals' manager, is a certified baseball genius, whose deft micromanaging will land him in Cooperstown. But this year, he inexplicably lost control of World Series Game 5, which almost gave the Rangers an opening to win the Series. La Russa gamely confessed afterward: "Man, this is stuff that I hope happens on a Wednesday game on the road someplace that nobody is there." Seeing giants stumble isn't restricted to baseball. Consider Reed Hastings, the CEO of Netflix, whose shares went from \$304 to \$120 in the four months before we referenced them in the October issue (and have dropped another 25% since). Hastings had graced the cover of *Fortune's* November 2010 issue, lauded as "The 2010 Business Person of the Year." But this year Netflix crashed to earth after alienating its adoring clients, which echoes something Daniel Kahnemann, a Nobel prize winning economist observed: "The damage caused by overconfident CEOs is compounded when the business press anoints them as celebrities; the evidence indicates that prestigious awards to the CEO are costly to stockholders," or "Don't believe your press clippings."

Ditto for Bruce Berkowitz, whom *Morningstar* named domestic equity manager not only of the year for 2009 but also of the Decade (2000-2009). Berkowitz's Fairholme Fund during that decade enjoyed an annualized 13.2% return thanks to shrewdly concentrating his portfolio in a very small number of stocks, while the S&P was flat. Berkowitz is a disciplined value investor, but this year his fund, of which 75% is invested in downtrodden financial services stocks that only got more trodden down, has lost 25.6%, while the average large cap value fund is off 3%.

As in baseball, business and investing, even solid leaders get it wrong. What matters is consistency. One year hardly matters. La Russa is retiring at the top. Hastings is working to right Netflix and Berkowitz is doing what he has always done. We'd not bet against him, though we now believe that he whom the gods wish to destroy (at least for a time), they put on the cover of a big-time magazine or dub him "Man of the Year (or worse, Decade)".

-Gray Emerson Cardiff

Looking back at how the Five for 2011 portfolio performed, we wince. It not only underperformed the overall market since we priced the group on November 5, 2010 and this issue. On average, the primary benchmarks averaged a 4% gain, paced by the Dow's 6.2% advance. Though our overall portfolio held its own, the Five for 2011 lost 8.4%.

What happened? Last November, the market was in rally mode. Indeed, the Five for 2010 portfolio, which we retired in that issue, had grown 16.8%, handily outperforming every major benchmark except the Nasdaq. Looking ahead, we expected that **Tetra Tech**, the environmental remediation engineering firm, **Transocean**, the ultra-deepwater driller, **Leucadia**, the poor-man's Berkshire Hathaway, **Boston Scientific**, the medical device manufacturer and **Dodge & Cox Stock Fund**, a low-expense value-oriented fund that had been battered during the 2008-2009 dive, offered a chance at substantial gains. For the first six months, these five roared as investors started to embrace our view that the U.S. economy was coming out of the Great Recession. But then the market began to focus on data that pointed toward not recovery but renewed recession. Now, with the exception of **Tetra Tech** (+3.9%), they gave up their gains.

Leucadia, which often trades with mining shares because of its exposure to that sector, in particular its 18% interest in Inmet, the Canadian copper miner, also owns financial services companies, which have had a very difficult year. Industrial metals mining shares became sells as recession fears rose. **Dodge & Cox Stock Fund** (-0.9%) lagged the overall market as its exposure to Hewlett Packard as well as to several financial services companies hurt performance. **Boston Scientific**, the medical device company, which we expected could rise merely by stringing together several better-than-expected quarterly results to surprise a uniformly skeptical Wall Street, did that but more than once tainted that incremental progress with negative news.

As for **Transocean** (-19.6%), we had argued from the moment in April 2010 when its Deepwater Horizon rig, which BP was leasing from Transocean, exploded in the Gulf of Mexico that almost all of the liability for environmental damage to the Gulf and other economic consequences would fall to BP, not Transocean. As time passes, we are even more confident of that. However, being right about legal liability did not mean RIG was bullet proof. Just as RIG hit \$85, confidence in recovery waned, oil prices drooped and the drillers fell, hard. Even as recovery hopes are rekindled, RIG now has its own set of problems. We will test the rule that says doing the same thing over and over but expecting a different outcome is evidence of insanity. We make our case on the next page.

In summary, our preference for investing in four of these five did not pan out this time, but we'd be fools to abandon that approach, which has been the foundation for the long-term success we've enjoyed.

SA



Five for 2012

Sound Advice avoids top-down stock selection almost completely, that is, we do not try to identify an overarching view of the market that highlights certain sectors based on macro-economic themes. Instead, our portfolio, if it does include overlapping companies, does so because individually each position was compellingly out of favor and thus cheap on the basis of relative valuation. At the moment, the most attractive investment ideas do share a common theme: each is tightly bound to recovery in the U.S. economy. These Five for 2012 are stocks that are unpopular during periods of economic contraction. If we are right, then each of these companies could soar. If we are wrong, then the only thing that will buffer their performance will be the dividends that with one exception each offers.

Paychex (PAYX—Nasdaq) is the purest bet on economic recovery in the United States, since its primary business is payroll services for small to medium-sized companies. Given that unemployment has milled around 9% for months, the gloom surrounding PAYX and its larger competitor, ADP, which focuses on large to very large clients, is natural for investors who value companies by making straight-line projections based on current conditions. Thanks to that myopic view, Paychex is trading at historically low valuations.

Since we recommended PAYX last October at \$27.26, it's run as high as \$33.76 in early March when recovery was the common assumption and as low as \$25.27 in August when double-dip recession was the mood. At its current price, the shares trade at price ratios well below their historical 10-year averages. Price to Cash Flow and Price to Sales, for example, currently are just 57% of their averages, while Price to Earnings is at 67%. The 4.4% yield, also relatively high, is another valuation tool, especially nice because you can spend it.

What is odd about how little interest Wall Street is showing toward Paychex is that since we highlighted the company, each quarter has overshot analysts' projections. Management, still guided by Tom Golisano, the company founder and now Chairman, always has been shareholder friendly. And why not? Golisano owns 10.5% of PAYX. As management continues to pare down costs while increasing revenues, the potential for explosive price appreciation increases.

Paychex is a cash cow, since its expenses are modest. Aside from its sales staff in its 100 offices scattered around the U.S. (with some foreign activity as well), operating costs are relatively small. The balance sheet carries zero long-term debt, and cash flow has been able comfortably to cover operating costs, the dividend and acquisitions. This is still a very fragmented industry, and Paychex continues to bolt on new companies either to give it greater depth or to

edge into adjacent lines of business. For investors looking for a company with stable cash flow, extraordinary potential for growth and a nice, safe dividend, Paychex fills the bill. We recommend PAYX up to \$32.

AMN Healthcare (AHS—NYSE) is the smallest cap position in our portfolio, and thus the most vulnerable to the winds of Wall Street. From our February recommendation at \$6.16, the shares had soared by June to \$8.71 (+41%) when investors gave up on the U.S. economy. Why should worries about economic growth devastate a healthcare company? Aren't they supposed to be defensive? Not always. AHS' revenue depends on not just rising need for medical professionals as baby boomers age, but also on those professionals, primarily nurses, to be confident enough in their job prospects and those of their spouses, to take leaves, to move to new jobs or to retire. Get pessimistic about the economy and AMN loses its short-term appeal. We're still betting for economic recovery.

Earlier this month, AMN announced fine quarterly results for its core division, traveling nurses, that is, nurses who are placed with contracts of 90 days to one year as temporary replacements or reinforcements at hospitals and other care facilities. Thus, on a year-over-year basis nursing division revenues jumped 24.2%. There is plenty of room for growth, since even in this improving environment AMN's placements are half of what they were during the last boom period.

Also showing strong growth is the Managed Services Program division, which takes over managing temporary staffing for clients rather than just being one of many vendors providing workers on an ad hoc basis. We also found encouraging that AMN has been able to increase its billings per placement as clients sense a tightening in the supply of nurses, particularly in specialized areas such as Operating and Emergency rooms, Intensive care and Labor and Delivery. We'll know when good times really have returned when demand for general nursing positions booms.

Results for other divisions, notably temporary physicians placements (locum tenens) and permanent placements are not keeping pace with nursing. We were disappointed to hear that AMN is negotiating to sell its home care division, which though small, we thought had promise. The company is taking a \$32 million write-down in goodwill in anticipation of its closing in early 2012.

AMN by far is the biggest company in this very fragmented industry, and as the demographic tsunami of aging baby boomers surges through the medical care structure, demand for nurses, physicians, pharmacists and medical support staff will expand. Employers will need the flexibility

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firms like AMN provide when it comes to meeting those demands. We recommend AHS up to \$8.

Xerox (XRX—NYSE) is one of those companies, like Google, whose total domination of a product has turned its name into a verb. Unlike Google, which remains the go-to Internet search engine, Xerox's domination of black-and-white analog printing long ago vanished as its primary product encountered numerous competitors that turned simple office copying into a commodity with almost invisible margins.

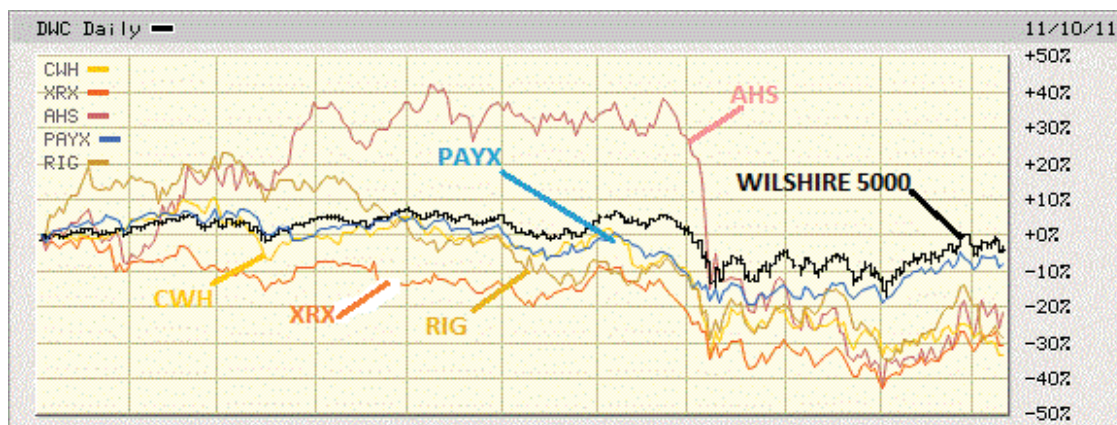
Though Xerox still produces those workhorse copiers, the thrust over the last few years has been development of digital printing machines, especially color units, capable of replacing printing presses to produce books and documents, and expansion of what had been a relatively small document handling business into becoming a major player in the outsourcing of back-office tasks for other companies, a

decade. We recommend XRX up to \$10.

Commonwealth REIT (CWH—NYSE) has been a disappointment this year. Like others in this group, its poor performance is a direct reflection of investor concerns about a slow economy, which for CWH means sluggish leasing demand for office and light industrial real estate. Occupancy rates are stagnant, rent increases slight and tenant leverage high. In its most recent quarter, all of these factors were evident. However, it's not just the macro climate.

CWH earned blame for the beating the shares have absorbed ever since management sprang a secondary offering of 11.5 million shares at \$24 back in July. Not only was that a couple of bucks under where CWH had been trading before the announcement, but the deal occurred just as the REIT market (and equities in general) got pummeled. The shares now are a whopping 27% under that \$24 offering price. The only good thing that can be said about

Five for 2012 vs Wilshire 5000 YTD Through the Rear View Mirror



the secondary is that the timing was exquisite. CWH cleared \$264 million just before the floor dropped out from under REITs in general.

Why then are we recommending shares that haven't been this cheap since mid-2009 and have distinctly trailed the overall REIT universe as well as an index of office/light industrial REITs? Moreover, why should shares that we

consider significantly undervalued based on the worth of this REIT's portfolio of properties not be doing better?

direction that last year's acquisition of Affiliated Computer Services (ACS) made clear. For many companies, color printing remains a luxury, not something that is affordable in a tight economy. However, Xerox is driving costs for color printing down, and as companies regain confidence in the future, we expect color to replace much of what is now done in black and white. Meanwhile, revenue from ACS has pushed the non-hardware portion of Xerox's sales into the company's primary business. We expect that to continue as Xerox expands its service segment outside the U.S. Again, small acquisitions are paving the way for globalization that builds on Xerox's brand recognition.

So why, aside from a still slow global economy, has Xerox faltered this year? First, as for many technology companies, the tsunami and earthquake in Japan has slowed the delivery of parts and especially has hurt Xerox Fuji, of which XRX owns a quarter. As management noted in its last conference call, Affiliated Computer Services landed several big contracts that involve upfront costs, which cut into operating margins at the outset but disguise how profitable these deals are.

Valuations are compelling compared not just to those of its competitors but also to Xerox's own price ratios over the last

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If you ask any REIT professional about CWH, the answer would start with the fact that it is an externally managed REIT, that is, unlike almost all REITs, CWH's properties are managed by another company, Reit Management & Research (RMR), which also manages all of the REITs that have been spun off from the original HRP Properties Trust (SNH, GOV, HPT). Because RMR is compensated based on the size of the portfolio, there is an inherent potential conflict of interest between what is best for the REIT and what is best for the external manager's income. We are not saying that the Portnoy family, which founded and continues to run RMR, is benefitting at the expense of shareholders, but the mere potential discourages buyers from holding CWH. Second, Commonwealth's portfolio historically has been built as a dividend generator, and has consistently been among the highest dividend payers in its sector. Now that is especially true: the yield stands at 11.5%.

The thinly traded iShares Industrial/Office REIT ETF yields 3.6%. A glance at office REITs of comparable market cap shows none yielding more than around 7%. For now, CommonWealth is an outlier. At some point, the spread

between the fat yield and those of its peers will shrink. The question, of course, is whether that will happen through a rising share price (good) or a reduced dividend (bad). Here is why we think there is a far higher likelihood for a rising share price.

Historically CommonWealth has owned suburban office properties with stable, high-quality tenants, many of them government agencies. CommonWealth spun off its government tenanted properties when it created Government Office Trust last year. CWH for the last couple of years has been undergoing a more gradual but equally important change: it has been selling off its suburban office properties and replacing them with central business district (CBD) buildings, which can command higher rents and are more highly regarded by financial analysts. For instance, during the last quarter, the REIT contracted to buy CBD office buildings in Chicago and Hartford and closed on three other CBD properties while agreeing to sell 16 industrial properties in Dearborn. CWH also sold to Senior Housing Properties Trust 13 suburban medical office properties.

We believe investors are not factoring these changes into their valuations for CommonWealth. In its most recent conference call (11/2), management says that it lately has slowed acquisitions as CBD property prices have become pricier and less attractive.

As with our other recommendations, current conditions do not favor CWH. However, if there is any single lesson we've learned about investing it is that taking a contrary position from what the market as a whole fears or favors eventually pays off. We acknowledge that "eventually" is not for everyone. We recommend buying CWH up to \$24.

As noted on page 1, [Transocean \(RIG—NYSE\)](#), one of last November's Five for 2011, failed to fulfill our expectations, though for the first three months RIG gushed to \$85 (+34%) before Wall Street abruptly decided in March that the U.S. and probably the global economies were destined for the dreaded double dip recession. Under that scenario, energy prices would collapse and take energy services companies like Transocean down with them.

As recently as October 4th, RIG, was at \$45, approaching its post-Macondo spill lows. But October marked another turn in market perceptions. Corporate earnings improved, GDP growth recovered to 2.5% and other macro-economic evidence began to accumulate to suggest that perhaps a synchronous global recession might not occur.

But in this volatile market, nothing stays the same. Earlier this month, RIG announced disappointing results for Q3, primarily the result of slow repair and recertification work on its fleet of rigs, especially deepwater units. At the same time, Transocean signaled that demand for the next couple of years—the extent of visibility—is increasing and pushing lease rates higher. If that proves to be true, despite the most recent quarter's results, RIG will run back to and through that \$85 recovery high.

Transocean in 2010 had been crushed in the wake of the explosion at BP's Macondo Well in the Gulf of Mexico as investors panicked over the prospect that RIG could be liable for what remains an uncalculated liability that could exceed \$20 billion for environmental, property and personal claims arising from the explosion and oil spill that blackened the Gulf of Mexico. Those concerns have receded as evidence builds that BP was the primary culprit. As important, BP is contractually obligated to indemnify Transocean for monetary claims, fees and fines associated with its role in the disaster except for very limited damage caused by explosion and sinking of Transocean's property at the well site. It did not help RIG's revenues that the U.S. government imposed a moratorium on all deepwater drilling, which hurt the entire sector and further deepened the gloom surrounding Transocean shares.

As with the other companies in the November quintet, if you believe the global economy is and will remain stagnant—or worse, then the only rationale for owning Transocean is the generous \$3.16 distribution (6.3% yield at the current price). However, if you can conceive of economic recovery, then RIG is in the best position of all the drillers to capitalize. Not only does it own the largest fleet of deep (drills to depths between 4600 to 7500 feet) and ultra-deepwater (below 7500 feet) drilling rigs (its next largest competitor owns about half of RIG's assets) and is recognized for its expertise in reaching and developing submarine energy deposits but is beefing up that fleet through acquisitions, recently buying a Norwegian competitor, Akers, whose small fleet consists of cutting-edge deepwater rigs designed to operate in harsh environments.

The moratorium imposed by the U.S. Bureau of Ocean Energy is being relaxed, and even BP has been greenlighted to bid on drilling permits in the Gulf of Mexico. Despite the finger-pointing between BP and RIG over responsibility for the Macondo catastrophe, we expect BP will turn to Transocean for its next Gulf project. Shares took a hit when the most recent quarter's results were published. Another drag on earnings is its fleet of shallow to mid-depth jack up rigs, which are suitable for wells in shallow waters and which afford Transocean no competitive advantage. Some will be refurbished to improve their versatility; others will be sold.

As for the \$3.16 distribution, management says it's committed to maintaining it, though conceding that should a compelling need for that cash arise (acquisitions, buybacks of shares etc.) it would review the dividend. We can't ignore the higher operating costs, should they persist, might convince management to trim the distribution. Still, Transocean is too well situated in what we believe will be a growth business to not like. We recommend RIG up to \$70. **SA**

Portfolio Updates

Since we priced the October issue, the Dow is up 9.5%, the S&P 9.4%, the Nasdaq 8% and the Wilshire 5000 9.8%. The *Sound Advice* portfolio grew 9.4%. Check below and on the Portfolio page for five sells. Pretty much anything associated with economic recovery showed good results, taking what investors had most distrusted (and punished) and turned them, at least for now, into gold.

A prime example is **Masco** (+27.5%), last month's recommendation, a manufacturer of kitchen cabinets, plumbing supplies, paints and a provider of home repair and insulation services. The same issues that were highlighted in the October recommendation (stagnant new construction, raw materials costs, inability to raise margins and dismal consumer confidence) persist. Early value-oriented buyers are betting on a recovery in new housing starts, which so far are no better in 2011 than they were in 2010. Consider the euphoric response to reports that confidence among home builders had "surged" by 4% to 18%. The problem is that 18% is what you expect to see in a recession. 50% is what you'd expect in a normal market. A step behind Masco is **AHM Healthcare** (+26.1%), the temp agency for nurses, physicians, pharmacists and other medical professionals. See page 2 for more on AHM. **Fastenal** (+23.2%) turned in the third best performance thanks to a nice quarterly report that featured higher margins against a background of slightly lighter sales, evidence of slightly better demand from manufacturers. **Honeywell** performed well, adding 20.4% on superlative quarterly results. Given HON's sprawling footprint, its results suggest that large industrial companies are finding ways to raise the bottom line. Another bellwether for the U.S. economy, **UPS** (+6.2%) presented a mixed conference call that conceded slightly lower revenues but better than expected results for the last quarter. Asian traffic, expected to be weaker in the quarter, was just that; UPS anticipates much stronger demand for the rest of the year. Significantly higher fuel costs are being passed along to customers without much resistance.

We are selling two interest rate sensitive positions. We have absorbed as much punishment as even we can take from **UltraShort 20+ Treasury ProShares** (+1.6%). Though we remain confident that long-term Treasury yields must rise, we finally concede that however irrational investors are, there is no way to know when that will change. We are also disposing of **PowerShares Senior Loan Portfolio ETF** (+6.7%), a bank-loan fund that we recommended as a tool to insulate cash should interest rates take off. As with TBT, we expect that at some point it will do just that. We're just weary from waiting for that day to arrive.

As for natural resources, **Anglo American** (+9.7%) paid \$5.1 billion for the 40% portion of De Beers Diamonds, which when added to its existing ownership totals 85% with the government of Botswana owning the remaining 15%. Anglo's profitability turns on a recovery in global growth, especially in Asia and most especially in China.

Fidelity Select Natural Gas Fund is up 17.9%, benefitting from rising oil prices. We are selling **EnCana** (+7%), which is almost entirely a natural gas exploration and development company, while FSNGX's constituents draw significant income from oil properties. Persistently weak prices for natural gas have frustrated our thesis that nat gas would rise to close the wide gap between it and oil. **Transocean** is up 7.6% to \$50.03. See page 4 for more.

Plum Creek (+5.8%), the lumber REIT, is up on the same fragile hope behind Masco's rise: that not only economic stagnation here at home is waning but also that home building might have seen its nadir. Were real estate to come out of the deepest funk of our lifetime, PCL would find its land in demand.

PowerShares Water Resources ETF (+10.9%) is benefitting from the resurgence in industrial shares, since despite its name, this fund marches more to the beat of industrial companies like Valmont Industries, Badger Meter, Lindsay and Aecom than to companies like **Tetra Tech** that derive the bulk of their revenues from water-related businesses. As for **Tetra Tech**, it reported sparkling results for the last quarter. TTEK is 19.6% to the good.

USAA Precious Metals & Minerals Fund (+10.3%) was glinting higher along with the price of gold as investors believe that Europe will cheapen the Euro to escape its financial crisis. Once more we are approaching \$1800 an ounce, a surge that continued through \$1900 earlier this year but did not carry mining shares with it. We believe that shrewder investors deemed that run an unsustainable mini-bubble and did not bid up mining shares. We'll get a chance to see whether the same skepticism persists for mining shares should gold bullion run through \$1900 again.

Leucadia added 4.6% during an extraordinarily volatile episode. Two of its primary holdings were under siege: mining shares, which were beaten down over concerns that China was slowing and Europe going into recession, and financials, in particular its 28% interest in Jefferies Group, which speculators targeted as another MF Global when a credit rating agency downgraded JEF after erroneously misinterpreting Jefferies' exposure to European debt. To its credit, LUK snapped up another 1% of JEF during the price swoon.

REITs are participating in the recent rally. **CGM Real Estate Fund** is back to its streaky self, adding 16.8%. Heebner has overweighted his portfolio with residential (26%) and retail (21%). **Associated Estates** (+12.9%), the apartment REIT, announced an 11.5% increase in FFO compared to the same quarter in 2010, but worried investors as its construction services division, which builds for others, faltered. As AEC is phasing out this service, the shortfall is moot.

Commonwealth REIT added 3.1% on a total return basis. See page 3 for more.

Retail Opportunities Investments, the strip mall REIT, continues to build its portfolio, adding six properties during the most recent quarter. Rising cash flow means that ROIC can continue to fill out its dividend, which expanded another 20% to 12 cents for the quarter. The yield is now 4.2%. Since the last letter, ROIC is up 8.7% on a total return basis.

Telecom New Zealand, has received shareholder approval to split into two separate companies. New Chorus will operate the hardware landlines and related infrastructure, while New NZT will retain the IT business as well as the international underwater cable that ties New Zealand traffic to the rest of the world. Most importantly, NZT's core will be its wireless communication division, which will compete against Vodafone and other wireless companies. We are selling NZT, since the split undoes what had recommended the company to us originally: growth through the potential of wireless and the nice dividend from the cash cow that was the legacy business that has now become New Chorus. If it is the divided that moved you to buy NZT, hold on to New Chorus. If it was the growth, hold on to New NZT. Since the last letter, NZT has added 7.1% and sharply outperformed its benchmarks.

We are also selling **GAMCO Global Telecommunications Fund**, which has outperformed the overall market during our holding period. We're concerned about telecom companies both because of the stagnant landline business as well as the overly competitive wireless business. Healthcare had a less torrid month, not surprising since it takes a backseat when investors get brave.

Pfizer (+8.4%) is in the news as its patent on Lipitor, one of the all-time biggest pharma successes, expires at month's end. The irony, that PFE should be rising just as what has worried investors most about Pfizer comes to pass, hammers home a very simple lesson: the time to have been worried about the damage Lipitor's loss of patent protection was several years ago when not once the market priced that loss into PFE. The time to buy PFE ideally was when the entire market bottomed in March 2009. We waited another year when it fell back to a couple of dollars above that low. Since then, we've collected a 4%+ dividend and enjoyed a 24% increase, well above the S&P's performance over the same period.

Stryker has fallen more than most from the late spring highs, losing as much as a third by mid-August. Since then, SYK has recovered but is still struggling, adding 3.3% since the last letter. Results posted in October exceeded expectations but management cut its sales growth targets, worrying about weaker European demand and weakness in sales for spine-related products. We've been through a similar bout of weakness for SYK when economic slowdown discouraged buyers. That was a good time to be a buyer. Now is no different.

BostonScientific also reported earnings, which met analysts' our expectations (nine cents a share) but were 25% under the same quarter last year. The shares tumbled that day, but did eke out a 5% increase as value investors started to seep back into these shares. Weakness in its core businesses (stents

and cardiac rhythm devices) accounted for the poor quarter.

As for consumer-related holdings, **Mattel** added 9.5%, after reporting a solid quarter with rejuvenated Barbie sales and international sales across the board. However, margins were weaker and Chinese workers are receiving higher wages, which along with higher raw material costs might account for those more modest margins. Mattel continues to buy back shares, which we continue to think represent a good value not just for its still above-average yield (3.2%) but also for the prospect of further price appreciation.

Wal Mart has been something of a barometer for the two-tiered economy as stores that cater to the upper middle class and above show strong results while Wal Mart, whose clientele is weighted toward blue-collar shoppers, has struggled at least here in the U.S. Same-store-sales continue to erode, while international business expands (and is helped by exchange rates). Last quarter earnings are due next week. Since the last letter, WMT is up 10.2% as investors try to anticipate an improving consumer mood amid slightly better macro numbers such as unemployment claims and significantly better consumer confidence numbers.

International Speedways, which hosts NASCAR and other motor events, like WMT is tied to blue-collar customers and like WMT benefitted this month from investor expectations. The shares are up 11.8%. The wildcard for ISCA remains its contract with Fox TV, which expires next year. With attendance and viewership down, investors have presumed that the next contract won't be as rich. Should that our expectation be wrong (2011 viewer numbers are up over 2010), even getting the same \$4.8 billion over the coming eight years would boost the shares. Then there is the new casino that Penn Gaming will open at ISCA's Kansas City venue. If that pans out, ISCA can repeat that at other tracks in states that allow casino gambling.

Superior Industries, which produces rims, wheels and other parts for the auto industry, did not participate in the rebound, and is flat since the last letter. We are puzzled by this failure to benefit from improving investor expectations, since if conditions are improving in the domestic economy, we'd expect manufacturers will need more of what SUP produces. But that did not happen. Consider that Ford and GM shares over the last month respectively added 10.5% and 5.1%, while SUP could only rise 1.4%.

CarMax, the used-car chain, did benefit from not just improving expectations but rising prices for used cars, and is up 11% since the last letter. Shares were battered in September after quarterly results were eroded by higher-than-expected purchase prices KMX found itself paying as demand drove up prices and accordingly cost KMX more. We will be interested to see if KMX in its next earnings report in late December will reap higher sales prices that will more than make up for the higher inventory costs that hurt results in the previous quarter. **SA**

Income With Growth	Symbol	Exchange	Price *	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$16.90	4.02%	\$18.25	BUY
CommonWealth REIT	CWH	NYSE	\$17.43	11.47%	\$24.00	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$11.45	4.19%	\$12.00	BUY
Telecom New Zealand	NZT	NYSE	\$10.66	8.12%	N/A	SELL
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$78.66	0.28%	\$100.00	BUY
CarMax	KMX	NYSE	\$28.40	0.00%	\$34.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$26.54	2.33%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$22.52	2.01%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$32.30	3.08%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$102.36	1.26%	N/A	BUY
Fastenal	FAST	NASDAQ	\$41.18	1.72%	\$44.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$19.69	1.83%	N/A	SELL
Honeywell	HON	NYSE	\$54.79	2.43%	\$60.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$24.47	0.65%	\$30.00	BUY
Johnson & Johnson	JNJ	NYSE	\$65.25	3.49%	\$71.00	BUY
Leucadia National Corp.	LUK	NYSE	\$24.08	1.04%	\$35.00	BUY
Masco	MAS	NYSE	\$9.55	3.14%	\$9.50	BUY
Mattel	MAT	NASDAQ	\$29.06	3.17%	\$32.00	BUY
Microsoft	MSFT	NASDAQ	\$26.91	2.38%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$41.02	2.34%	\$50.00	BUY
Paychex	PAYX	NASDAQ	\$29.40	4.35%	\$35.00	BUY
Pfizer	PFE	NYSE	\$19.99	4.00%	\$23.00	BUY
Stryker Corp.	SYK	NYSE	\$49.48	1.46%	\$60.00	BUY
Superior Industries	SUP	NYSE	\$16.47	3.89%	\$22.00	BUY
Tetra Tech	TTEK	NASDAQ	\$22.53	0.00%	\$28.00	BUY
Third Avenue Value Fund***	TVFVX	800-443-1021	\$43.50	2.22%	N/A	BUY
Time Warner	TWX	NYSE	\$35.21	2.67%	\$40.00	BUY
United Parcel	UPS	NYSE	\$70.78	2.94%	\$74.00	BUY
UnitedHealth Group	UNH	NYSE	\$47.13	4.41%	\$53.00	BUY
Wal-Mart Stores	WMT	NYSE	\$59.20	2.47%	\$64.00	BUY
Xerox	XRX	NYSE	\$8.21	2.10%	\$10.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$19.70	0.00%	\$25.00	BUY
EnCana	ECA	NYSE/TSE	\$20.32	3.94%	N/A	SELL
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$32.17	0.17%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$36.79	4.57%	\$44.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$17.06	2.36%	\$21.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$41.93	10.98%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$5.01	0.00%	\$7.00	BUY
Boston Scientific	BSX	NYSE	\$5.90	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$24.99	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$11.23	7.75%	\$11.81	BUY
Maxim Integrated	MXIM	NASDAQ	\$26.75	3.29%	\$29.00	BUY
PowerShares Senior Loan Portfolio ETF	BKLN	NYSE	\$24.25	4.16%	N/A	SELL
Seligman Premium Growth Fund	STK	NYSE	\$16.97	10.91%	\$20.00	BUY
Symantec	SYMC	NASDAQ	\$17.12	0.00%	\$22.00	BUY
Tellabs	TLAB	NASDAQ	\$4.32	1.85%	\$5.50	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$10.29	8.67%	N/A	BUY
Transocean	RIG	NYSE	\$50.03	0.00%	\$75.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$20.41	0.00%	N/A	SELL

* Prices as of Friday, November 11, 2011

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

*** Note ticker symbol changed to TVFVX

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

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

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

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

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

The Key Indicator

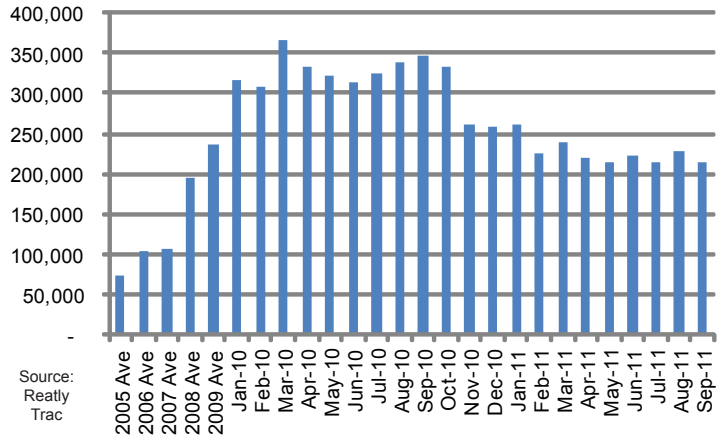
The secret is to focus on foreclosure rates. Realty Trac in Irvine, California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We use some of their data here to gauge the state of the nation and its real estate, and plan to continue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

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

The following chart shows US foreclosure rates. In 2005, foreclosure rates averaged 74,892 properties per month. In 2006 and 2007, foreclosures were slightly above 100,000 per month. However, by January 2010, foreclosures climbed to over 300,000 per month, and foreclosures continued at over 300,000 each month through October.

We saw the beginnings of a decline in the 2010 fourth quarter. At first, the decline was due largely to a freeze in foreclosures by several major lenders. The downtrend continued as Federal and state foreclosure prevention efforts allowed distressed homeowners to stave off foreclosures.

US Foreclosure Rates - Monthly Averages



These efforts have included mortgage assistance programs for the unemployed and mediations that have been resulting in loan modifications.

Dissecting the Foreclosure Process

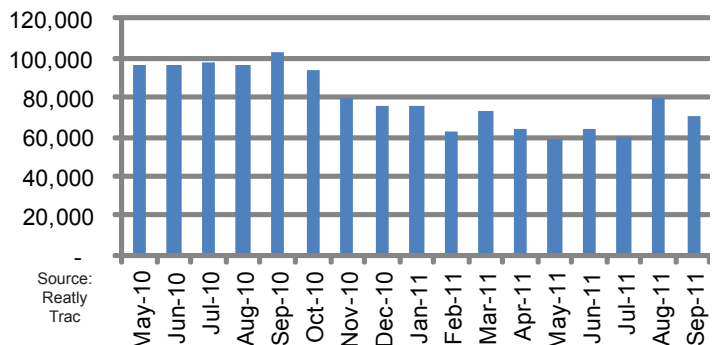
It's important to keep in mind that the foreclosure process is comprised of three distinct stages: new default filings by lenders; then auctions as lenders attempt to sell these properties; and finally, bank repossessions of those properties not sold through auctions. The sheer number of foreclosures is actually the aggregate of the number of properties in each of these three stages.

We can get an early glimpse of a change in trends by focusing on changes in the first step of the foreclosure process: new default filings. After all, a significant change in the first step of the foreclosure process must ultimately lead to a significant change in the aggregate number.

The following chart shows new default filings in the US by month since May 2010. Through October 2010, new default notices were hovering around 100,000 per month. However in November they began declining and dropped to a low of 58,815 in May, and July was almost that low at 59,516

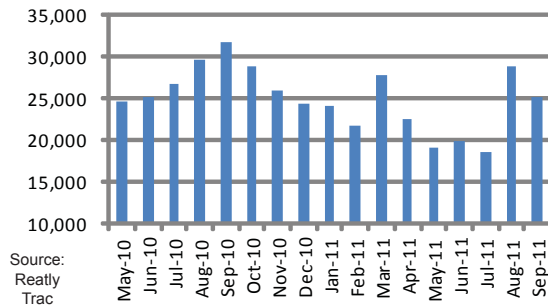
However, in a marked turnaround, August new default filings leaped by 33 percent, to 78,880. Although new default filings declined ten percent in September, they were still high at 70,710. Until these latest readings, it appeared that the problem was no longer getting worse. But that no longer is the case. The crisis will be getting worse in the immediate future.

US New Default Notices



Further confirmation comes from our largest state, California. Below is a chart of new default notices there.

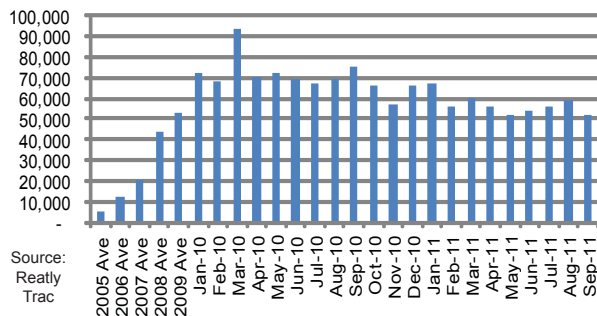
California New Default Filings



For the month of August new default notices in California jumped a whopping 55 percent. Although the latest reading in September declined by 13 percent, new defaults in California were still exceedingly high.

The chart below shows all stages of the foreclosure process in California (including auctions and bank repossessions).

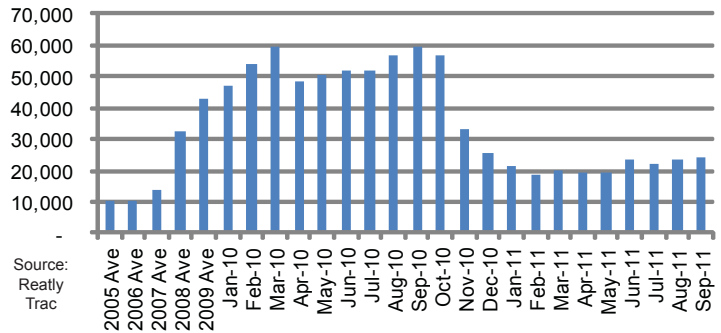
California Foreclosures - Monthly Averages



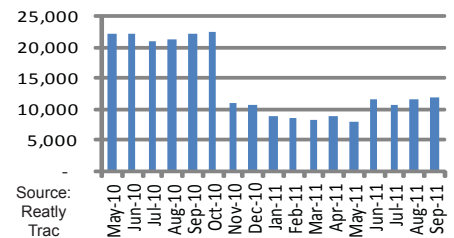
In 2005, California foreclosures averaged 5,138 properties per month. Foreclosures doubled in 2006, and again in 2007, and again in 2008. By 2010, foreclosures were close to 70,000 each month, with a spike of 93,000 in March. Foreclosure rates were declining until August when they rose 5.7 percent to 59,383. However, we know from the high amounts of new default filings that foreclosure rates in California in August and September that foreclosures will be climbing in the months ahead. This is significant because one fourth of the nation's foreclosures have been in California for the last few years.

Florida is the next highest foreclosure state with 11.2 percent of the nation's foreclosures. Foreclosures climbed from 10,000 per month in 2005 and 2006 to 47,000 in January 2010, and stayed in the 50-60,000 range through October. Then the rate dropped sharply. See the following chart:

Florida Foreclosures - Monthly Averages



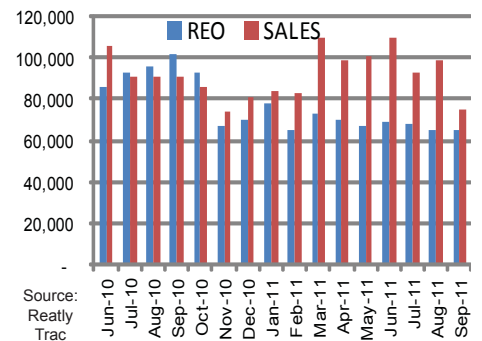
Florida New Default Filings



However, foreclosure rates have been inching up in Florida during the last three months. As an indicator of what lies ahead, new default notices have been persistently high during the last four months.

The Inventory

At the other end of the foreclosure process is what the banks have not been able to sell. This inventory is called "real estate owned", or REO for short. Each month more REO is added to the inventory. However, each month there are a number of properties sold from the inventory. Above is a chart of the REO (in blue) and sales (in red) during the last year.



On balance, there has been 244,659 more properties sold than have been added to the REO inventory, or 17.6 percent of the inventory of 1,390,689 foreclosure properties currently listed for sale. While there is progress, there is still a significant amount of inventory to go.

Conclusions

The recent increases in new default filings is evidence that lenders are starting to push through foreclosures delayed by past bungling (robo-signing) and moratoriums. That means the crisis will be getting worse before it gets better.

We will be tracking foreclosure metrics closely both nationally and in key states in these pages of SoundAdvice to be among the first to know when the end of the foreclosure crisis is at hand. Stay tuned.

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

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

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

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

We can, therefore, label this new tool a "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the Risk Indicator will rise over the line

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

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$7,434,412 in stocks and to \$1,087,234 in houses.

But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$295,482,332, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets. A recent example was during the 1998-2000 stock market mania, when most investors were chasing high-tech stocks, our *Sound Advice* portfolio was buying Real Estate Investment Trusts (REITs.) Most investors got killed with 75 percent-90 percent losses during the ensuing decline. However, REIT shares during the same period soared 25 percent, and had locked in nearly double-digit dividends. When the bear market ended in late 2002 and tech stocks recaptured some of their losses, REITs rolled to mind-boggling highs as speculation drove them to excess that climaxed in 2007.

The SoundAdvice Risk Indicator

The latest reading for the **Sound Advice** Risk Indicator is 1.49. This reading reveals that stock values are about 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 renew your subscription.)



Business Cycles and Stocks: The **SoundAdvice** Diffusion Indexes

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

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

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

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

The Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators 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.

An "Aggressive" signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. The current reading of the Diffusion Index of Leading Indicators is 25 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which would reveal an overheating economy with immediate inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 16.7 percent.

Track Record of the Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 produces an annual average return of 22.5 percent. During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent during caution periods.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

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

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