

What If We're Wrong?



What's the latest fad for the fast buck crowd? Currency trading, one of the most volatile sectors in all of investing that is dominated by professional investors and battle-tested speculators. Why anyone would think they can match wits, information and nerve with such counterparties is beyond me, but the Wall Street marketing machine knows how to tempt suckers. The evidence is compelling that currency trading and small investors don't mix well. For instance, two weeks ago (4/11) *Barron's* front page soberly noted "Small Traders Lose Big in Currency Casino," a not surprising conclusion given, as the story notes, that "Roughly three-quarters of individual investors who trade through forex firms like Gain Capital Holdings lose money."

I'm always grateful when the financial media points out that just because financial services companies are touting new ways to get rich, it doesn't follow that even the financial service innovators believe what they're selling. However, in what is the journalistic equivalent of selling a teen ager a hot car and then buying life insurance on the kid, *Barron's* just a month before was touting currency trading.

Unlike the brief cautionary tale about the dangers of currency trading, *Barron's* earlier cover story in mid-March was: "The Money Whirl: The dollar's swoon is drawing more investors to the \$4 trillion-a-day foreign-exchange market. Which currencies look best. How to play them." The story sprawled over three pages and stirred those animal spirits, concluding: "It's time to mint some real money." Admittedly the "Small Traders Lose Big" piece is concerned with individuals trading futures contracts: highly leveraged positions in undercapitalized accounts that Gain let clients "fund" with their credit cards, while the breathless piece from March does conclude that most small investors would be better off using ETFs and other diversified investments rather than futures. Still it offers the names of firms like Gain Capital as an alternative.

Personally I'd never touch currency trading. Yet for some the prospect of quick gains and the availability of products that if you're dumb lucky enough to pick the right horse, can deliver those gains is too much to resist. Opportunity may knock just once, but temptation never stops.

-Gray Emerson Cardiff

"What if we're wrong?" That question haunts not just guys who try to defuse bombs but also investment advisers. In fact, it was posed in an opinion piece written hours before the 2008-2009 bear market ended. The author cautioned against getting into the market at that moment, and certainly never to take a buy and hold approach. He called buy and hold investing a "risky Rambo strategy." We couldn't agree less. The real "Rambo" approach is trying to outsmart the market by trading in and out.

We've always thought that a long-term commitment to an investment offers a better way, though we're not prepared to follow Warren Buffett, who has said that his holding period usually is "forever." Even our buy and sell signals, which set the general investing environment, are broad business cycle prompts that coincide with economic peaks and valleys, respectively less and more propitious times to get into the market. Still, we are inclined to stay with our ideas for extended periods.

Not surprisingly, the anti-buy and hold argument soars during bear markets. Google Trends, a nifty way to track the frequency of particular search terms, shows that use of "buy and hold" peaked along with the bear market in 2009. Nearly every instance condemned patience. Just weeks after the market had begun its recovery but before anyone recognized it, the *Wall Street Journal* reported ("Advisers Ditch 'Buy and Hold' For New Tactics Facing Angry Clients, Pros Turn to 'Alternative' Products; Risk of Missing a Turnaround") that money managers were jettisoning long-held views because "the macro economic climate has changed." Remember the "New Normal," which also involved forgetting about traditional investing strategies like buy and hold? Plus their clients were clamoring that they "do something."

There is scant evidence that "doing something" when markets sour works. Consider the repeated studies of funds' long term performance versus the performance of their shareholders. Without exception, shareholders, who respond to bad news and falling prices by selling and good news and rising prices by buying never get it right for long. In 2009, DALBAR, which provides research to Wall Street, published statistics that showed over the previous 20 years the S&P 500 enjoyed an annualized return of 8.35%, while the average stock investor accumulated a paradoxical 1.87% annually, significantly below the 2.89% rate of inflation. John Bogle, who has a messianic devotion to index funds, performed a similar study on how ETFs did versus their holders. Over a five year period ending in mid-2009 the ETFs outperformed their shareholders by 4.5% because the shareholders instinctively bought high and sold low.

One caveat about buy and hold. Though patience is essential, buying when valuations are sky high and then holding forever is nowhere near as profitable as buying when valuations are low, which is what *Sound Advice* aims to do. Consider the consequences of buying Cisco in early 2000 when the shares traded above \$80 and then holding. More than a decade later, the shares are trading at \$17.65 and will need to compound at a 16.3% rate over the next decade to regain \$80. On the other hand, buying CSCO today and holding should work out nicely—if you have the temperament. **SA**



Income and Inflation Protection

The single question most often posed to us lately has two facets: first, how can I get a higher rate of interest on my cash and how can I mitigate the risks of rising interest rates? For most investments, getting more return without accepting greater risk is not possible.

The first question has been the income investor's mantra since the Federal Reserve plunged short-term rates effectively to zero. The second question, though lurking in the background ever since rates plunged, now is emerging as the even bigger issue. But the two facets reflect one reality: due to the accommodative interest rate policies at the Federal Reserve and the still weak economy that prompts that policy, current interest rates across the yield curve are unnaturally cheap and make putting your money under the mattress seem almost reasonable. Economists describe the current interest rate environment as "zero bound," that is, rates cannot decline further because they are effectively at zero (if you reduce those stated or nominal rates by the rate of inflation, you get the real rate, which at the short-end is decidedly below zero).

Rates literally have nowhere to go but up, but when does that happen? We can't say, but the pressures are building. *Sound Advice* has nibbled at strategies to deal with these problems. The **Third Avenue Focused Credit Fund** with a portfolio of non-investment grade debt provides higher yield, while common stocks such as **CommonWealth REIT**, **Associated Estates** and **Telecom New Zealand**, are geared toward above average income. Companies with strong cash flow but depressed share prices (**Johnson & Johnson** and **Pfizer**) provide above-average income today and anticipate significant capital appreciation tomorrow. But none of these investments can claim confidently to have significant insulation from rising interest rates, though an argument might be made that REITs can weather inflation better than other sectors. For a hedge against rising interest rates, we hold the **ProShares UltraShort 20+ Year Treasury ETF**, but there's no income component. Then there are Treasury Inflation Protection Securities (TIPS) and funds that hold them, but these depend on the Consumer Price Index, which, we believe, does not correlate perfectly with market rates.

Loan Participation Funds

There is one type of investment that combines income and significant rate risk protection: loan participation funds. Also known as senior debt, floating rate or bank loan funds, these invest in adjustable rate bank loans to less-than-investment grade borrowers. Such loans are tailored to specific companies' circumstances and trade outside of a regular market, which makes them illiquid and unavailable to the average investor.

Loan participation funds have proliferated in the years since we last recommended them (1998) but till now we've been ambivalent about them. Ultimately we decided that because closed-end loan participation funds and almost all mutual funds focused on this sector use leverage to boost yield and all carried relatively hefty expense ratios, they presented more problems than benefits.

Avoidance of high fees is an obvious issue, and after the pasting that leveraged funds experienced when the credit markets seized up in 2008 and early 2009, we learned that the added income leverage provides is trumped by the risk introduced. We do not want anything to do with a leveraged loan participation fund, which brings us to **PowerShares Senior Loan Portfolio Fund (BKLN—NYSE/ARCA)**, an Exchange Traded Fund (ETF) that debuted last month. Not only does it not use leverage to boost returns but it also carries a much lower expense ratio than any other senior loan fund.

BKLN is one of the few ways investors can enjoy a significantly higher return...while providing substantial protection against ...a rise in interest rates that would decimate fixed-rate investments' market value. That it does this inexpensively compared to other funds and avoids the leverage risk such funds contain further recommend BKLN. It's a fund that fits the times.

So how do loan participation funds provide superior income but also protect against rising rates that would erode the value of your principal? Like junk bond funds, loan participation funds hold debt from less than investment-grade borrowers, which means higher yields but also higher risks of default. The two critical differences between the portfolios of high-yield bond funds and loan participation funds are that should a borrower default and go into bankruptcy, the loan participation debt is senior to the "high yield" debt and thus will get better treatment in bankruptcy. Indeed, bank loans are backed by specific assets such as real estate, machinery, accounts receivable and other tangibles. Junk bonds put the lender relatively low on the payout pyramid.

Second, while the covenants for some junk bonds might include conditions under which the interest rate could rise, most interest rates are fixed. Bank loans are always pegged to floating rates (usually a fixed amount plus a changing rate, usually 90-day LIBOR), which in a rising rate environment is very valuable. Most floating rate loans adjust their interest payments every 30 or 40 days. Currently the PowerShares fund's portfolio has on average 37.9 days to reset. Of course, it's a two-way street: when rates fall, yields adjust lower. With short-term rates still zero-bound, that does not concern us.

Over the last two decades, were three periods during which the Fed raised rates consecutively: February 1994-February 1995, June 1999-May 2000 and June 2004-June 2006. In each, fixed-income investments suffered and loan participation funds prospered. There is no reason to think that once rates begin to rise, whether through actions of the Federal Reserve or through market forces, the same pattern won't be repeated.

Because the PowerShares fund debuted last month and has made only its first distribution (it will pay out on a monthly basis), we can only approximate what the annual distribution will add up to (simply multiplying the first month's return by 12 won't work, since not all loans in the portfolio will have paid their distributions during this brief period). Based on the underlying index's return, we expect a yield between 3.5% and 3.9%.

The portfolio nominally has an average duration to maturity of 4.5 years. What do other fixed-income investments offer with five-year durations? Five-year Treasuries yield 2.17%. A 60-month CD yields around 2.4%. A 5-year AAA corporate bond yields 2.2%, a 5-year AA 2.07% and a five-year A 2.96%. High-yield paper with a five-year maturity pays in the 5% range. With the exception of the CDs, each, is vulnerable to rising interest rates. However, the real comparison should not be to five-year duration debt, since BKLN's notes have floating rates. The comparison should be to money market funds and ultra-short duration notes. The shortest duration U.S. Treasuries (90 day) yield 0.03%. Bankrate.com reports that the average yield on taxable money market funds currently tops out at 1%. Given not only that the income is taxable (Treasury income is not taxed below the federal level) and that the stated rate of core inflation is running at around 2%, anyone who wants income but fears inflation is in a very tough place.

The Portfolio

BKLN is trading on average just under 100,000 shares a day during its brief existence. Under normal circumstances—something we need to get back to below—the fund's price should not be volatile.

As an ETF the fund is obligated to hew to an established index but BKLN does that with a twist. Rather than replicating the entire index, the managers must use a sampling technique to produce a virtual version because, for reasons we explain below, it puts part of its portfolio into closed-end senior-debt funds, which means its portfolio cannot match perfectly its underlying index, the Standard & Poor's/LSTA [Loan Syndication and Trading Association] U.S. Leveraged Loan 100 Index, which encompasses the 100 largest loans contained in the larger (1000 loans) S&P/LSTA U.S. Leveraged Loan Index. The assumption is that larger loans are less susceptible to default and also more liquid.

So what does it own? The portfolio includes the debt of several corporations from multiple loans, and if those are combined for each borrower the three largest positions are First Data (4.5%), primarily a processor of credit card data. It was taken private in 2007 by KKR in a \$29 billion deal, of which \$24 billion was debt and ranked as one of the biggest LBOs in history. Four years later, First Data is generating positive cash flow, and paid \$1.5 billion in interest on loans

made to be taken private and to fund operations. The notes (BKLN participates in three separate issues) pay 2.75% over LIBOR (3-month LIBOR currently is 0.28%). Last month, First Data announced a new Senior Loan offering (\$750 million) with a 2019 maturity date, part of whose proceeds would be used to retire previous notes, perhaps those held by BKLN, since they are among the earliest of the LBO's notes to mature (2014). However, any retirement of one note in one position would immediately be restored by participation in the new issue, since following the underlying index requires BKLN to participate. The next largest (3.9%) is Texas Competitive Electric Holdings, another 2007 LBO that involved KKR, this time in conjunction with Goldman Sachs and Texas Pacific Group. What had been the largest electric and natural gas utility in Texas was taken private for \$45 billion. These also mature in 2014. It too generates positive cash flow from its customers.

The third biggest position, HCA, the hospital chain, accounts for 2.9% of the portfolio. HCA, unlike the first two positions, once again is a publicly traded company, but these notes

BKLN UNDERLYING INDEX SECTORS		S&P 500 SECTORS	
Services/Retail	24.9%	Information Technology	18.1%
Media	19.1%	Financials	15.8%
Healthcare	15.0%	Energy	13.3%
Industrial	12.3%	Industrials	11.3%
Telecom	5.2%	Healthcare	11.1%
Computers & Electronics	5.1%	Consumer Discretionary	10.4%
Other	5.0%	Consumer Staples	10.2%
Gaming & Hotel	4.9%	Materials	3.7%
Forest Product	3.2%	Utilities	3.2%
Food & Beverage	1.8%	Telecom Services	3.0%
Real Estate	1.0%		
Building Materials	0.9%		
Metals & Mining	0.9%		
Entertainment & Leisure	0.7%		

continue as part of the publicly traded company's capital structure and mature anywhere from 2012 to 2017.

As we worked through the entire portfolio, it became obvious that with few exceptions, bank loans today represent financing done to facilitate the privatization of publicly traded companies during the 2005-2008 leveraged buyout frenzy that, like the real estate bubble, depended on the availability of plentiful, relatively cheap money to borrow.

It's worth looking at the sectors into which the fund has concentrated its holdings and compare that with another benchmark, the Standard & Poor's 500 Index. As the above chart shows, though the sector designations Standard & Poor's employs for each index are not always identical, the divergences are still evident. For example, sectors like telecom and media are overweighted while financials, the S&P's second largest sector, are non-existent in the BKLN portfolio.

The weightings reflect no decision making by the fund managers. Rather, since the underlying index is weighted by the size of the outstanding loans, it stands to reason that the largest bank loans, almost all of which were floated during that 2005-2008 LBO frenzy, are in industries that were most in demand during the period.

There is one other important dimension to the portfolio. Currently 10.5% consists of closed-end funds that invest in loan participation funds. The prospectus advises that up to 20% of the portfolio can be in such overlapping funds, and it's reasonable to ask why? It certainly is not for diversification, since these closed-end funds' portfolios duplicate most of the existing positions in BKLN's own holdings. Rather, these funds are something of a reserve, a source for cash should shareholders in large numbers abruptly decide to sell their shares and the ETF, in order to satisfy that demand, needs to sell something. Trying to sell portions of individual bank loans during what would be an unfriendly period for such assets (why else would the ETF be seeing massive selling?) would be extremely difficult because bank notes, even when they come from the largest issues, are relatively illiquid. In a cash crunch, shares in these closed-end funds would be far easier to liquidate and thus would provide a relatively easy source for quick cash. There is another layer of protection should redemptions become urgent. The fund in an emergency is authorized to borrow funds up to one third of its NAV.

However, as much as owning closed-end funds that in a pinch could be sold and having the ability to raise cash might sound reassuring, anyone contemplating owning this fund should understand that in a crisis, those closed-end funds would be falling in tandem with BKLN. As for the ability to borrow during an emergency up to a third of the portfolio's NAV, that too would be punishing. Still, these defenses do provide a mechanism for preservation and demonstrate that the fund managers understand the risks inherent in these assets.

One other consideration. Both closed-end and mutual funds that are built around loan participation notes have high expense ratios. The average expense ratio for closed-end funds in this sector exceeds 2% with the cheapest ratio at 1.3%. Open ended mutual funds without a front-end sales charge even higher expense ratios. BKLN charges 0.83%, which is high for an ETF but low for this asset class. That spread, though it might seem modest, over time gives BKLN a serious advantage.

The Risks

Loan participation funds and BKLN in particular provide income and insulation against interest-rate risk, but default risk, even when mitigated by collateral behind these notes, cannot be ignored. Keep in mind that the floating rate debt market is heavily weighted toward companies that were taken private during the last decade, many at prices that in today's economy appear overblown. Their acquirers, at least when the leveraged buyouts occurred, had relatively short-

horizon plans. They presumed that they could improve the operations and market value of their new companies, and then in a few years cash out by bringing them back in an IPO or by finding a private buyer.

The 2008-2009 collapse of the credit markets and the ensuing deep recession slowed those plans and in the weakest cases resulted in bankruptcies. Were the U.S. economy to slip back into recession, we'd see more defaults and bankruptcies, and though recovery rates through asset sales might come close to making floating note holders whole, the process would take time and, at least for a period, would hurt the ETF's share price. We mention these concerns, not because we see them as likely. Without being Pollyanna, *Sound Advice* sees an improving economy, which will be a positive for the sorts of companies whose debt the fund holds.

As we noted when explaining why we are avoiding leveraged funds, the 2008 credit market collapse was a nightmare for almost all securities, but none suffered more than high-yield debt and that includes loan participation notes, which tumbled more than 30% as over-leveraged holders dumped wave after wave of notes onto a market without buyers. There was a disconnect between the underlying value of assets and what they were fetching in that dysfunctional market. Prices returned to rational levels in 2009, as these same assets soared 50%, a trend that has continued as investors are flocking to senior floating note funds to capture superior yields without raw interest-rate risk. BKLN's avoidance of leverage to boost income would provide some protection were we to see another such disconnect, but the fund still would be buffeted by the same winds and would see extraordinary price volatility.

As investors have bought into the senior loan market, spreads have shrunk. At present, bank loans are selling almost at par (97 cents on the dollar), which some see as evidence that the market has become complacent about the risks in non-investment grade debt. From our perspective, higher pricing on bank loan debt, though it does demonstrate investors are comfortable with high yield debt and loan participation notes, do not explain why. The most cynical explanation is that with almost free money flowing from the Federal Reserve, why care about debtors' ability to service their debts? Certainly this plays a role. However, the debt market also could be anticipating that the fitful economic recovery we have today will strengthen and permit the leveraged buyouts to succeed. Historically levels of default are low during times of economic expansion.

The PowerShares Senior Loan Portfolio today is not a value-oriented proposition. Instead, it is one of the few ways investors can enjoy a significantly higher return than short-duration debt offers while providing substantial protection against what we see as an inevitable rise in interest rates that would decimate fixed-rate investments' market value. That it does this inexpensively compared to other funds and avoids the leverage risk such funds contain further recommend BKLN. It's a fund that fits the times. **SA**

Portfolio Updates

The market came back to earth over the last couple of weeks, washing away some of the gains built up during the March rally. It's easy to point to troubling headlines dominating the news: Japan's nuclear crisis, civil war in Libya, political and social turmoil elsewhere in the Mideast and even in countries like Egypt and Tunisia, where revolutions have resulted in the overthrow of the old regime, looming question marks about what happens next. The weaker European nations are back asking for bailouts and China has raised interest rates to curb fast rising real estate and food inflation. Here at home, the tribal nature of political divisions both in Washington and in the states augurs ill for political compromise to solve our many real and pressing problems. S&P's warning about U.S. debt's rating summed that challenge up nicely.

Against this backdrop, the major benchmark indexes were led by the Dow Industrials, which posted a 1.4% gain thanks to its inclusion of the twin energy companies, Exxon and Chevron. The others lagged, ranging from the pan-market Wilshire 5000's barely visible 0.1% to a flat S&P (-0.1%) and a losing Nasdaq (-0.8%). The *Sound Advice* portfolio posted a 1.1% gain.

The March issue featured analyses of changes in the portfolios of funds we hold, and as such was not meant to highlight underpriced positions. Yet, as a group they outperformed (+2.5%) not just the overall market but the rest of the portfolio as well. That outcome got boosts from the **CGM Realty Fund**, which again is showing evidence of its manager's willingness to stretch the definition of "real estate" to include natural resource stocks, is up 3.1% even though natural resource stocks were front and center in the current market retreat, **Hambrecht & Quist Life Sciences Fund** is up 10.4% and the **PowerShares Water Resources Fund** increased 0.9%. The **Fidelity Select Natural Gas Fund**, benefitting from buoyant energy prices in the wake of both threatened Mideast oil shipments and concerns that nuclear energy as a solution to high energy prices and environment problems is now undercut, had been cruising higher but got knocked down to finish the month off 1.7%. The **Columbia Seligman Premium Technology Fund**, dropped 1.8% as tech in general had a rough month, which even STK's options strategy that generates income could not temper.

The portfolio got its biggest boost from **Superior Industries**, the manufacturer of rims and wheels and other parts primarily for GM, Ford and Chrysler. Superior reported quarterly results on March 16th, a few weeks before the tide of earnings reports started. The results were superb, and seemingly came as a shock to the market despite Wall Street being well aware that SUP's customers have been reporting for months their own strong sales increases. SUP since we last priced the portfolio is up a whopping 23.4%. There are some questions about how disruptions in the availability of parts

supplied from Japan might slow down vehicle production for Superior's customers and thus impact Superior, but so far such questions have not cooled investor interest.

Our two other auto-related positions traveled in different directions. **CarMax**, which runs the largest chain of used-car dealerships in the country, dropped 5.6 % after reporting much stronger results for the quarter. It wasn't the higher sales and earnings that caught Wall Street's attention. Instead, investors homed in on slightly higher reserves against losses on loans made by KMX's financing arm. If the economy is improving, we expect loan losses to be a diminishing problem for CarMax, and would add shares now.

International Speedway, which runs tracks that host high profile NASCAR races as well as other events, wowed Wall Street in the first quarter and seems to be gaining traction. It is up 10.3% since the last letter. ISCA still has problems but as the predominantly young, male blue-collar fan base begins to find jobs or to feel more confident about the jobs they already have, ISCA should have less trouble filling the stands and selling beer and souvenirs with higher margins than it's had when unemployment was trending higher.

Other consumer-related shares also did well since the last letter. **Molson Coors**, which has been weak this year and has a history with road racing, added 8.2%, and **Mattel**, the toy-maker, moved up 5% after a solid earnings report followed on the heels of a dreary report from its primary competitor, Hasbro. **Wal Mart**, which had been suffering as higher gasoline prices threatened to limit its blue-collar customers' spending, bounced back, adding 3.5% as the company announced it was jettisoning a marketing program that had featured wider, less cluttered aisles intended to make shoppers think "luxury." Apparently turning the aisles into retailing mine fields sells more.

AMN Healthcare, which appeared in the February issue, continues to push forward, up another 5.3%, closing at \$7.97, though earlier it reached as high as \$8.66. Its rise was fueled by stronger quarterly results reported in early March that showed growing demand in the healthcare sector, which augurs well for a company that provides temporary staffing at hospitals in positions ranging from registered nurses to physicians. However, another position intimately tied to job creation and economic recovery, **Paychex**, which provides payroll services and ancillary support to small and medium sized companies, has slipped 2.7% despite late last month coming through with very encouraging quarterly results that featured an increase in checks cut per client, a clue to where job growth is occurring in the U.S. Add in more cost efficiencies and improved revenues and we get a clearer picture of where PAYX is heading. We'd be buyers on this price weakness.

As noted, tech stocks have been weak of late, perhaps

responding to dire events occurring in Japan, home to many consumer electronic companies. In our own portfolio, **Maxim Integrated** has lagged the most, down 9.2%. **Microsoft** drooped 2.2%.

Better performances came from **Symantec** (+4.5%) and **Xerox** (+2.7%). Now that Intel has absorbed McAfee, SYMC is the lone independent provider of security tools for individuals and small businesses, something we see reflected in rising subscription revenues. As for XRX, the last significant news came in February when quarterly results showed good if not explosive revenue growth.

Shares of natural resource companies have been all over the board since the last letter. **Transocean**, the ultra-deepwater driller whose shares have been climbing back from the high \$30s last year, had been as high as \$85 in early March, slipped back since the last letter, down 11% as investors' mood continues to swing about the diminishing likelihood of significant financial losses stemming from the Deepwater Horizon's destruction in the Gulf of Mexico and the subsequent environmental calamity. Sentiment got dented at the end of last week, when the company announced it was disposing of three older rigs. That decision in part reflects some weakness in the land-based and shallow-water divisions, but also turned on the rigs' advanced age. We expect soon to hear about a schedule for RIG to pay out the long-delayed dividend that was ready to be rolled out just before the Deepwater Horizon incident occurred in mid-April last year.

Tetra Tech, which centers on water quality remediation, moved up 0.9%, down from where it stood at the start of April. **Plum Creek Timber**, the timber REIT, is up 3.6%. PCL can be one way to play a recovery in the housing and construction industries as well as the overall economy while receiving a 4% dividend that is treated as a long-term capital gain. Remember that most REIT distributions, because they represent pass-through income not taxed at the corporate level, do not qualify for the 15% federal tax rate. PCL's distributions do because they represent a capital gain. **Agrium**, the fertilizer producer, is off 8.3%, perhaps in response to rising prices for natural gas, which is the primary feedstock for AGU's nitrogen-based fertilizers.

But metals were mixed. On the industrial side, **Anglo-American** tumbled 4.5%, while precious metals, especially silver, rumbled higher. **USAA Precious Metals & Minerals Fund** increased 2.1%. Watching the price of gold and silver move higher, we were puzzled by a lag in the gold mining companies' shares. Usually miners move anywhere from twice to triple price changes in the underlying metal, but that was not the case earlier in March. In the end, the miners played catchup over the last week or so. One puzzle: if gold is moving on fears of inflation, why then are interest rates edging lower? The **ProShares 20+ UltraShort ETF** fell 5.1%. We can only presume that it's not a bet on falling interest rates, but a flight to safety from an unsettled world that made U.S. Treasury securities desirable for the moment. Long term, we are confident the story will turn out otherwise.

Leucadia, a holding company that often responds to the metals market since it owns pieces of several mining companies, did not go along for the ride lower. Instead, the shares added 10.2%, for which there is no obvious explanation LUK is something of a black box. The company is closed-mouth and its two principal executives come out once a year, in their annual report, to explain themselves. When the company acquires a new asset, shareholders are left to dope out why on their own, since few analysts follow Leucadia. But LUK's success exceeds by a wide margin the success of Berkshire Hathaway.

Healthcare was mixed, lagging earlier in the month and then strengthening as the market got nervous. The very strong move in the **Hambrecht & Quist** closed-end fund reflected a broader interest in biotechnology companies, which might augur well for the entire healthcare industry. Aside from HQL and AHS, discussed above, the best performer (+4.4%) has been **Pfizer**, which is peeling off some of its non-core businesses. The latest transaction involved the sale of its capsugel line (as the name suggests, this division produces encapsulated drugs for both Pfizer and external customers) to a private investment company for \$2.4 billion. PFE is mulling over more sales of non-core businesses and cut backs on expenditures. Our other mega-healthcare company, **Johnson & Johnson**, is caught in its own version of groundhog day, as over and over again it announces recall after recall for everything from musty smelling OTC products to hip replacements. We persist in thinking that JNJ will escape these rounds of stupidity. Since the last letter JNJ is off 0.8%, though it got some good news when it settled legal wrangling with Merck over drugs that Merck acquired when it bought Schering Plough.

Boston Scientific continues to bounce around, off 6% on nothing in particular. Indeed, news has generally been good for BSX, but the company has dug itself so deep into Wall Street's doghouse that it will take a consistent run of good quarters and positive developments before anyone other than deep value investors take an interest in the company. The turn, when it comes, will be dramatic.

Stryker has given back 4.4% from what is shaping up to be a very good year (+13% ytd) that reflects SYK's strengths: no debt, lots of cash on the balance sheet, commitment to research and development and good diversification beyond its orthopedic division. It remains a good buy at these levels.

UnitedHealth, the HMO, continues to run higher, adding 1.2%, and like other HMOs is having a fine year (+26% ytd) as investors realize that the healthcare law is no HMO killer. What investors should worry about are political attempts to smother the law. Though CGM had a good month, **Commonwealth REIT** and **Associated Estates** did not kept pace. CWH eked out a 0.4% increase but AEC slipped 0.5%. We believe both, based on the value of their properties, continue to trade at an attractive discount. CWH with a 7.4% yield is too attractive to ignore. SA

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
Associated Estates Realty Corp	AEC	NYSE/Nasdaq	\$15.98	4.26%	\$17.00	BUY
CommonWealth REIT***	CWH	NYSE	\$26.86	7.45%	\$30.00	BUY
Telecom New Zealand	NZT	NYSE	\$7.97	9.01%	\$9.00	BUY
Diversified Growth						
Agrium	AGU	NYSE/TSE	\$88.53	0.25%	\$100.00	BUY
CarMax	KMX	NYSE	\$33.20	0.00%	\$38.00	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$28.53	2.17%	N/A	BUY
Comcast	CMCSA	NASDAQ	\$24.49	1.85%	\$28.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$36.93	1.34%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$113.77	1.13%	N/A	BUY
Fastenal	FAST	NASDAQ	\$64.95	2.19%	\$70.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$21.71	1.66%	N/A	BUY
Honeywell	HON	NYSE	\$57.75	2.29%	\$62.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$30.66	0.52%	\$32.00	BUY
Johnson & Johnson	JNJ	NYSE	\$60.56	3.57%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$35.81	0.70%	\$38.00	BUY
Mattel	MAT	NASDAQ	\$26.80	3.43%	\$29.00	BUY
Microsoft	MSFT	NASDAQ	\$25.37	2.52%	\$31.00	BUY
Molson Coors Brewing	TAP	NYSE	\$47.86	2.01%	\$54.00	BUY
Paychex	PAYX	NASDAQ	\$32.39	3.83%	\$40.00	BUY
Pfizer	PFE	NYSE	\$20.53	3.51%	\$23.00	BUY
Stryker Corp.	SYK	NYSE	\$60.70	1.19%	\$70.00	BUY
Superior Industries	SUP	NYSE	\$24.36	2.63%	\$27.00	BUY
Tetra Tech	TTEK	NASDAQ	\$23.30	0.00%	\$30.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$54.28	1.78%	N/A	BUY
Time Warner	TWX	NYSE	\$36.05	2.61%	\$40.00	BUY
United Parcel	UPS	NYSE	\$72.71	2.86%	\$79.00	BUY
UnitedHealth Group	UNH	NYSE	\$44.98	1.11%	\$49.00	BUY
Wal-Mart Stores	WMT	NYSE	\$53.55	2.73%	\$60.00	BUY
Xerox	XRX	NYSE	\$10.73	1.60%	\$14.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$25.45	0.00%	\$30.00	BUY
EnCana	ECA	NYSE/TSE	\$32.95	2.43%	\$37.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.15%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$42.37	3.97%	\$48.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$19.82	0.52%	\$21.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$41.96	10.97%	N/A	BUY
Aggressive Growth						
AMN Healthcare	AHS	NYSE	\$7.97	0.00%	\$8.50	BUY
Boston Scientific	BSX	NYSE	\$7.08	0.00%	\$8.50	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	0.00%	N/A	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$12.41	6.93%	\$12.67	BUY
Maxim Integrated	MXIM	NASDAQ	\$24.97	3.36%	\$29.00	BUY
PowerShares Senior Loan Portfolio ETF	BKLN	NYSE	\$25.27	3.50%	\$27.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$19.62	9.44%	\$22.00	BUY
Symantec	SYMC	NASDAQ	\$18.52	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd	TFCVX	800-443-1021	\$11.60	7.20%	N/A	BUY
Transocean	RIG	NYSE	\$75.58	0.00%	\$90.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$36.69	0.00%	N/A	BUY

* Prices as of Friday, April 15, 2011

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

*** Name and Ticker changed from HRPT (HRP--NYSE)

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 to not only invest in real estate for pennies on the dollar at the right time, but also in other investments as well that benefit from a recovering economy.

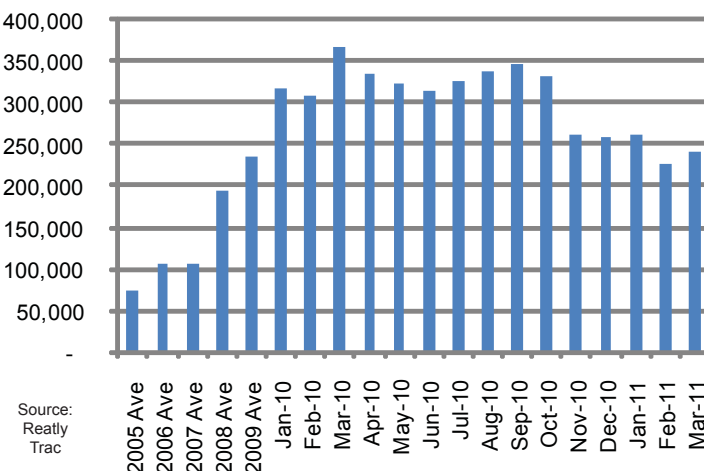
The Key Indicator

The secret is to focus on foreclosure rates. Fortunately, Realty Trac in Irvine California has an extensive data base. You can access foreclosure information on local markets from their website www.realtytrac.com. We 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**.

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

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

US Foreclosure Rates - Monthly Averages



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

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.

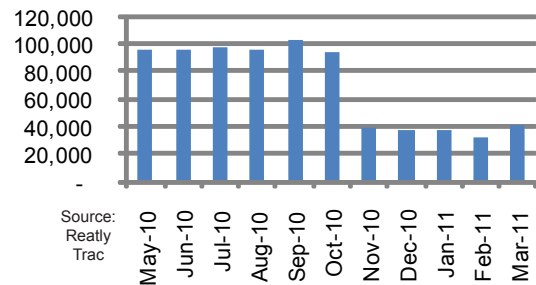
We saw the beginnings of a decline in the fourth quarter. However, there was a freeze by Bank of America on 102,000 foreclosure actions. JP Morgan Chase also had a freeze on 56,000 actions. The GMAC unit of Ally Financial also had a freeze.

Then in the first quarter the industry was plagued by bungled paperwork and lost documents, which has severely restricted the ability to process foreclosures.

In January, foreclosures increased by 1.4 percent, declined in February by 13.9 percent, and increased again in March by 6.5 percent. While the result for the first quarter was a net decline of 7.0 percent, the volatility indicates that there is no clear trend yet. When the paperwork mess is resolved for the most part, which may take several months, data will be more reliable and a clear trend should emerge.

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

US New Default Notices



This chart shows new US default filings by month since May 2010. Here again we can see the effects of the freeze and paperwork bungling since October. The 26 percent increase in March, the latest data available, is not a good sign. We will be keeping a close eye on new default filings.

Where are the Foreclosures?

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

Foreclosure Activity - March 2011

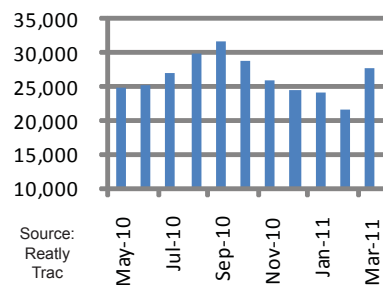
	Number of Properties	Percent of Total	One in every	Monthly Change
US	239,795	100.0%	542	6.5%
CA	60,241	25.1%	223	7.1%
FL	19,710	8.2%	449	5.1%
AZ	15,705	6.5%	175	1.4%
MI	14,615	6.1%	311	4.4%
GA	13,052	5.4%	311	1.9%
NV	12,900	5.4%	88	35.0%
IL	12,053	5.0%	439	25.7%
TX	11,018	4.6%	883	-4.7%
OH	9,112	3.8%	559	6.0%

Nevada (NV) has earned a reputation as the foreclosure capital. That is because it has the highest number of foreclosures in relation to the number of houses there. The table shows that 1 of every 88 houses was foreclosed upon in March, which is the highest concentration of foreclosures in the nation. While that may be important to a homeowner or real estate investor in Nevada, other states are a larger burden on the national economy. The largest 4 states are shown on the right, with California accounting for the most foreclosures by a large margin.

Since one-quarter of all US foreclosures were in California, any changes in foreclosure trends there could lead to a significant change in the trend for the national economy as a whole. Foreclosure rates are still bouncing around at high levels there, with a 7 percent increase in March.

The chart to the right shows new default notices in California which jumped 28 percent in March after declining for 5 months.

California New Default Notices

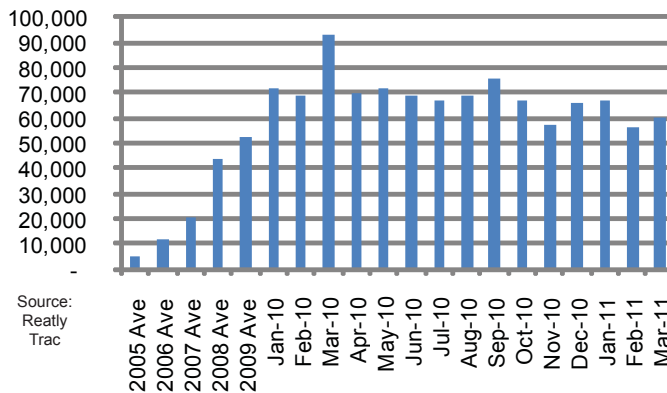


Conclusions

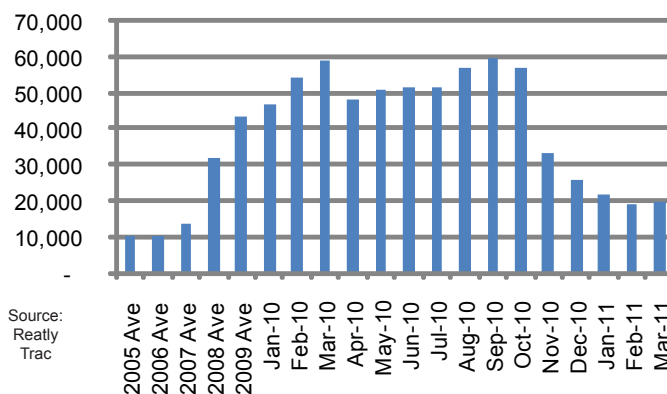
Foreclosure rates in March were up nationally and in all the top foreclosure states except for Texas. These results reveal that the foreclosure crisis is still ongoing, especially in light of the paperwork bungling that has been restricting the foreclosure process and holding down foreclosure rates.

We will be tracking foreclosure metrics closely in these pages of **SoundAdvice** to be among the first to know when the end of the foreclosure crisis is at hand. That will mean you can make enormous profits in real estate, as well as other investments that benefit from a robust economic recovery. Stay tuned.

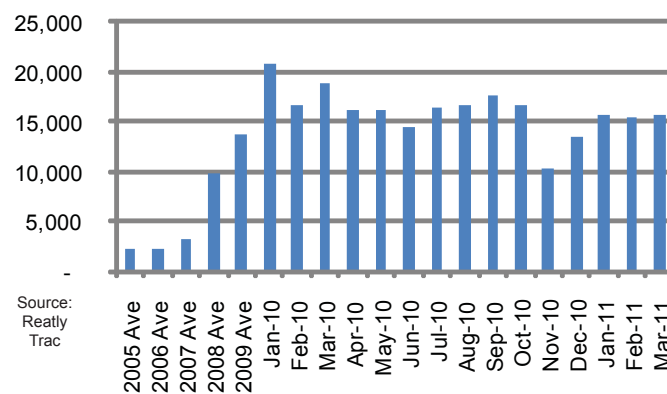
California Foreclosures - Monthly Averages



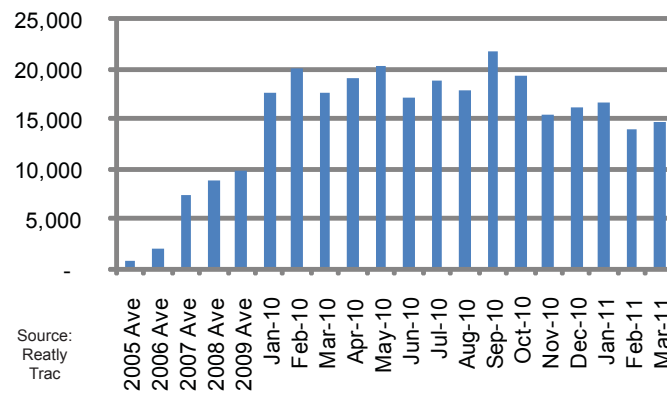
Florida Foreclosures - Monthly Averages



Arizona Foreclosures - Monthly Averages



Michigan Foreclosures - Monthly Averages



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 \$7,762,647 in stocks and to \$1,075,000 in houses.

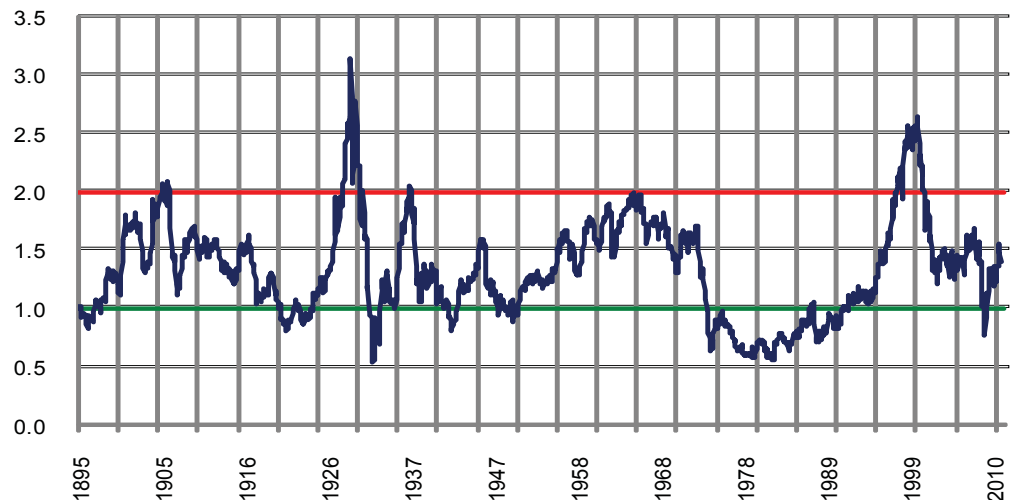
But though an investment begun with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the Risk Indicator he would have made \$308,533,337, or 39.7 times more money—the difference 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 1.40. This reading reveals that stocks are slightly above their average relative 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 is 75 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 33.3 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 23.4 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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