Gray Cardiff's

SOUND ADVICE

Volume XXI, Number 3 Subscription Rate: $195 per year March 14, 2008

A subscriber last year sent us an “independent research firm’s” hosannas about an income-oriented REIT that the subscriber has owned with justifiable pride since 1984. Researching last month's issue, I again looked at it.

As these things often do, when the "research" was written last year, the party was about to end. Even though the REIT fund has fallen in price, we have no problem with it. It has performed well, and as an income investment continues to do what informed shareholders expected.

But I do have a big problem with "research" trumpeting “15% Returns, Less Risk Than A Bank Account,” and assuring “your principal is safe,” because the REIT at the time had a $3 billion market cap. Nonsense. The common since then has fallen 19%, taking the market cap with it.

The report also boasts that the REIT’s portfolio is not mortgaged, which technically is true, but fails to note that it issues bonds and preferred shares to buy properties to pay its increasing dividend. This debt, like any mortgage, must be serviced before common shares get a penny. For naive investors hungry for yield, "research" like this comes close to pandering.

It is arrantly irresponsible for anyone to blur the difference between “a bank account” whose principal is insured by the FDIC and an equity that can guarantee neither stability of principal nor continuity of income. There is nothing wrong with investing in this REIT, but you have to understand what you own. Don't confuse wishing something to be true ("less risk than a bank account") with the truth.

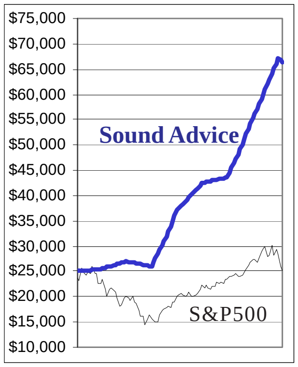
--Gray Emerson Cardiff

Market Versus Intrinsic Value

Back in 2002, Warren Buffett agitated Wall Street by questioning the wisdom of derivatives, much loved on The Street because they were so useful and so lucrative and in academe, because they were so complex. Take Buffett’s prescient remarks in that year's shareholder letter (http://www.berkshirehathaway.com/letters/2002pdf.pdf), which termed derivatives “financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.” The Berkshire Hathaway chief was troubled as much by derivatives’ deceptive complexity as by human nature. Even honest players, Buffett observed, demonstrate a “human tendency to take an optimistic view of one’s commitments.” Add to this the incentives to close the deal, and players are seduced into seeing the payoff not the pitfalls. Thus, “[C]ontracts involving multiple reference items and distant settlement dates increase the opportunities for counter-parties to use fanciful assumptions…The two parties to the contract might well use differing models allowing both to show substantial profits for many years. In extreme cases, mark-to-model degenerates into what I would call mark-to-myth.”

Buffett also anticipated the cascading consequences were derivatives to have problems: “[M]any derivatives contracts require that a company suffering a credit downgrade immediately supply collateral to counterparties. Imagine, then, that a company is downgraded because of general adversity and that its derivatives instantly kick in with *their* requirement, imposing an unexpected and enormous demand for cash collateral on the company. The need to meet this demand can then throw the company into a liquidity crisis that may, in some cases, trigger still more downgrades. It all becomes a spiral that can lead to a corporate meltdown.” Sound familiar?

Sound Advice versus the S&P 500



Since 1-1-2000, an Investment of $25,000 becomes:

$25,246 with the S&P 500 (for a profit of $246)

$66,382 with *Sound Advice (for a profit of $41,382)**

= 167 Times More Profits

* These returns assume an equal amount is invested in all ***Sound Advice*** Model portfolio positions at the time of the initial recommendation.

Market Versus Intrinsic Value

So perhaps it comes as a shock to read in the 2007 letter that Berkshire uses derivatives, though its versions have almost nothing in common with what is crushing financial stocks. As Buffett says, his own derivatives enjoy two great benefits: first, in each case, Berkshire is being paid to accept the risk, and thus there is no chance that the counterparty, the other side in the deal, won't be able to perform, which, of course, is the problem today with so many of the structured loan derivatives. Second, Berkshire's portfolio is not at the mercy of market volatility. Buffett recognizes that derivatives, even the straightforward ones Berkshire participates in "will sometimes cause large swings in reported earnings [my emphasis], even though Charlie [Buffett's sidekick]and I might believe the intrinsic value of these positions has changed little. He and I will not be bothered by these swings – even though they could easily amount to $1 billion or more in a quarter – and we hope you won't be either. You will recall that in our catastrophe insurance business, we are always ready to trade increased volatility in reported earnings in the short run for greater gains in net worth in the long run. That is our philosophy in derivatives as well."

"Reported earnings"/ "intrinsic value," for Buffett can be opposing indicators. Buffettologists expend much energy trying to determine precisely how Buffett calculates an asset's intrinsic value, but for our purposes, let's say that "intrinsic value" is Buffett's shorthand for real value. "Reported earnings" is also shorthand for how under the wrong circumstances by using Generally Accepted Accounting Principles (GAAP) you can get a distorted value of an underlying asset.

At times, like now, the gap between real value and GAAP pricing can be huge, which brings us to **American International Group**, which has caused us, and those of you who bought shares on our recommendation, pain recently. AIG has been in free fall primarily because of debt market turmoil, especially that part structured around mortgage debt, as investors try to determine what the correct or clearing price is for their holdings. In some cases, the riskiest, lowest grade and most junior collateralized mortgage obligations, those most likely to get stiffed by underlying mortgages that never will be paid, are considered toxic and, if they are traded, do so at pennies on the dollar, which probably is close to their intrinsic value. However, the same confusion also is playing havoc with more stable debt instruments that continue to be serviced and show no signs of default. With few willing buyers and only desperate sellers, the prices for what does trade are extraordinarily weak.

Buffett's remarks in 2002 about derivatives were made post-Enron, when suddenly we saw what can happen when senior executives employed fountain pens and fancifully structured contracts to steal from shareholders and lenders. In response, new accounting rules compelled CFOs to value derivatives and other contracts on their books at market prices. However, when markets are in chaos and when the few trades that do occur are forced, prices do not fairly represent those derivatives' intrinsic value. Huge write-downs on both the balance sheet and income statement are mandated. That, we believe, is what is happening at AIG and elsewhere. The impact on AIG's share price has been unnerving, but we believe that once debt markets regain stability, much if not all of these write-offs could be reversed, and both earnings and assets would flow back onto earnings statements and balance sheets.

Is this a guarantee? Hardly. In fact, ours is a fairly lonely position, though Chairman Bernanke in response to questions after his testimony before the Senate conceded that the mark-to-market system might be creating unreliable prices, but that it was not his problem to solve. For a more involved explanation, we recommend the latest shareholder letter from Marty Whitman (http://www.thirdavenuefunds.com/taf/documents/pdf/TAF_1Q_ShareholderLetters.pdf) for his to-the-point criticism of the mark-to-market fallacy when applied to portfolios of performing instruments intended to be held to maturity, as is the case at AIG. Last month, in "Agony of Early" we wrote skeptically about Whitman's investments in monoline insurers burdened with such portfolio issues. Reading his latest comments leads us to temper that skepticism. Nonetheless, Whitman could be right and still get his head handed to him by a market that seems to have lost its head. ***SA***

Gray Cardiff's Sound Advice is published monthly by S.A. Newsletters, LLC. Editor-in-Chief: Gray Emerson Cardiff. Managing Editor: Steve Horwitz. Executive Editor: Linda Cardiff. Office Manager: Angela Castellano. Subscription rate: $195 per year. Send subscription requests to: Sound Advice, 939 Hartz Way, Suite 210, Danville, CA 94526. Phone: (925) 838-6710. Fax: (925) 838-0522. Information presented in Sound Advice may be used provided the newsletter—its name and address—is mentioned as the source. The information contained herein has been carefully compiled from sources believed to be reliable, but accuracy cannot be guaranteed. ©2008 S.A. Newsletters, LLC.

When securities are initially recommended herein, the editors, affiliates, and associates of the editors do not have positions in such securities and are required to wait at least seven days from the date Sound Advice is mailed before placing orders for them. Editors and staff members may own stock of companies discussed herein.

Second Opportunity

For the first time in four years, we have the opportunity to buy shares in one of the best value-oriented mutual funds: **Dodge & Cox Stock Fund (DODGX)**. We own and have owned others, such as the estimable **Excelsior Value & Restructuring Fund** or several **Third Avenue** funds, but DODGX is unique. There are funds with somewhat higher performance numbers, certainly there are better-known (or publicized) mutual fund groups and without doubt most other fund families have in their stable a horse for every conceivable need or want. Dodge & Cox currently has four funds: this, its flagship, a balanced fund, a bond fund, and an international fund that we own. DODGX combines performance, longevity and a remarkably consistent discipline.

We had to sell DODGX from our portfolio in 2004 when it closed to new investors, which automatically triggers removal from the *Sound Advice* portfolio. Dodge & Cox Stock Fund, which we said in our 2002 recommendation, was "the best mutual fund you never heard of" has been in business since 1965, spends not a penny on advertising and discourages media attention. Despite its disinterest in display, it became a magnet for cash. Ironically, with the outflows that hit in 2007 as evidence, we suspect that much of that was momentum money, which is exactly what Dodge & Cox is not about.

DODGX's anonymity ended as it began popping up on lists of best performing funds. From 2000 to 2006, the fund handily outperformed its benchmark, the Standard & Poor's 500 Index. In fact, investors' enthusiastic support for DODGX when combined with appreciation in its Net Asset Value took assets under management from $4.6 billion at the start of 2000 to $29.4 billion at the start of 2004, shortly after which the fund was closed to new investors. At its peak last June, assets under management exceeded $72 billion.

Early last month, we alerted you thatDodge & Cox reopened the fund (as well as its Balanced Fund). Now we want to provide a full discussion of what the fund is and what it is doing not only because we think it is a keystone investment but also because watching how DODGX works is a lesson in value investing. How long the fund will remain open is unclear, but with investors, now worried more about return of capital than return on capital, pulling cash out of all mutual funds, and value stocks no longer dominating the market, we expect Dodge & Cox won't need to nail the transom shut anytime soon.

DODGE & COX

You can pick up just about any Dodge & Cox letter to shareholders at any time during its 43-year history and find the same message. There have been a few tweaks, such as more exposure to non-U.S. companies. Otherwise, the approach remains steady. Management aims long-term to be fully invested, though from time to time defensively might increase its cash position. Currently DODGX is 98.7% invested in equities, its highest point this decade. Though DODGX focuses on domestic companies, it can invest up to 20% of its assets in foreign ADRs traded in the U.S., and can augment that with shares of foreign companies listed on American exchanges that are included in the Standard & Poor's 500 Index. Since 2000 that percentage has climbed to the current 19.2% (13 foreign holdings), the largest of which are France's Sanofi-Aventis ($1.9 billion/3.1% of assets), Japan's **Sony** ($1.9 billion/3%) and Matsushita Electronics ($1.9 billion/2.9%) and British GlaxoSmithKline ($1.6 billion/2.5%)—all of which are among the 15 largest positions in the 85-stock portfolio. Dodge & Cox is no dilettante when it comes to investing internationally. Indeed, earlier success with non-U.S. investments in both its stock and balanced funds encouraged management in 2001 to introduce an international fund **(DODFX)**, which relies on the same methods, analysts and management committee responsible for the domestic investments. That fund, which we hold in our portfolio, has also outperformed its benchmarks since inception.

All Dodge & Cox funds rely on a team of analysts, whose suggestions are reviewed and utilized by a management team, whose nine members average13 years of experience in the shop. The research is intensely focused on fundamentals, and is never fazed by market volatility. Indeed, when markets go wobbly the mood at Dodge & Cox seems more resolutely upbeat.

So why did Dodge & Cox reopen last month? Recall that management closed the fund in early 2004 because so much cash was flowing in from new and existing investors that prudently investing it threatened to overwhelm the managers' disciplined investing style. Even after restricting additional inflows to existing shareholders or 401(k) and similar plans, cash continued to swell the fund's assets. From 2000 through 2002 DODGX had averaged a 5% return while the S&P showed an annual 15% loss. In 2003, the fund outran the S&P by 3.7% and in 2004 by 8.3%. However, in mid-2007 as equity markets became more difficult, especially in the value sector, shareholders began to pull out. Ironically, the very conditions that convince some shareholders to run for the exits, create the best environment for Dodge & Cox. As the company notes in announcing the re-opening: "the volatile investment environment has created what we believe to be many interesting long-term equity and fixed income opportunities."

THE DODGE & COX WAY

As Dodge & Cox observed in its 1999 year-end letter just as the tech-driven bull market was about to rollover: "The elements of our investment approach are unchanged. Using a long-term (three to five year) investment horizon, we seek to identify and invest in high- quality business franchises with reasonable valuations. We now view approximately half of the equity market as unattractively priced. We become very cautious when investor exuberance causes wide valuation disparities in the equity market, and especially when the high-valuation segment grows increasingly concentrated in a single economic area. Avoiding the high-valuation area means we have the remaining half of the domestic equity market (plus some non-U.S. companies) as the universe from which to build a diversified portfolio."

We believe that DODGX based on its long-term performance can continue over the long-term to provide a 2% premium over its benchmark, the S&P 500. Given that currently DODGX holds positions in 14 companies also in the *Sound Advice* portfolio, the fund shares our attitudes and instincts when it comes to value investing.

That letter frankly reveals a flabbergasted management that in its professional careers had never seen such excesses in valuation and exuberance. However, they resisted the notion that some new investing paradigm had made their experience obsolete. Glancing at other exhilarating runs within the market's not-so-distant memory, they pointed out the intoxicating PC boom of the early 1980s and the runaway energy sector during the late 1980s. When each collapsed, they ushered in deep bear markets for both technology, which underperformed the S&P from 1983 to 1990 by 50% and energy, which went in the tank from oil at $40 a barrel to the infamous *Economist* cover story of March 1999 ("A World Awash in Oil") that predicted oil would go to $5 a barrel. The pendulum swings wide both for exuberance and despair.

Indeed, Dodge & Cox's 1999 indifference to what was hot was rewarded almost immediately. The following year's report allowed management to survey the previous three years, which included the fund's worst (1998) and at that moment the best (2001) annual performance relative to the S&P 500: "At the beginning of this three-year period in 1998, investors faced a great deal of uncertainty as the global recession threatened to destabilize the growth of the U.S. economy. At the same time, valuations for a handful of stocks ("the New Nifty Fifty") rose to unprecedented levels. For Dodge & Cox, perseverance and a long-term view became key. We avoided the highly valued areas of the market and increased the Fund's investment (through 1998 and 1999) in low-valuation companies with inherent strength, but operating in a very difficult global environment… Without question, the Fund's underweight position compared to the S&P 500 in technology and telecommunication stocks was the largest contributor to the Fund's strong relative returns (more on that later), but a number of other areas were strong contributors as well."

If Dodge & Cox underweighted the high-valuation tech stocks, it did not avoid technology. Even after the bear market had humbled the biggest cap tech names, Dodge & Cox still refused even to nibble on them, since they still sold at valuations, such as price to sales, which were unappealingly high. But there were pockets within technology, especially the so-called "old technology" names such as Hewlett Packard that were trading at very attractive valuations, and this is where the fund concentrated.

Hewlett Packard is a best-case example of how Dodge & Cox's approach works. The fund in the late 1990s held a modest number of HP shares, which by the end of 2000 had dropped under one million. Twelve months later, as the tech gloom thickened, the fund owned 6.7 million shares. Over the next five years, the position would explode to nearly 66 million shares, and now accounts for 4.4% of the fund's assets. DODGX built that position during the Carly Fiorina years, when Hewlett Packard acquired Compaq and when Wall Street wondered whether anyone, especially Fiorina, the beleaguered CEO, could salvage this old tech warhorse.

Dodge & Cox built this position at prices that remained below its first significant buys. HP's share price would not trade above that initial entry price till the start of 2006. HP at the end of last year stood at $52.77 (today it is at $47.31), a level not seen since September 2000, well before the fund began to build its HP horde.

If we look at the portfolio more broadly, we can see how DODGX sculpts it. At the end of 2002, just as *Sound Advice* began to beat the drum for natural resources, DODGX had four times the exposure that the S&P 500 had to metals and mining, paper and forest products and chemicals, all of which soared thanks to demand for natural resources. But over 2003, materials dropped significantly to an underweighting, while financials rose to more than triple the S&P's exposure. Between then and mid-2007 financials boomed. In 2004, the fund's energy exposure was two and a half times that of the S&P. In 2005, the overweighted sector was information technology, especially hardware. In 2006 and last year, the overweight was in consumer discretionary with an emphasis on media stocks such as **Comcast**, **Time Warner** and News Corp. That sector has been a major drag on performance. Not surprisingly, last year, for the first time since 1999, DODGX underperformed the S&P 500, eking out a 0.1% total return versus the S&P's 5.5% gain for the year.

In a declining market and slowing economy, Dodge & Cox is in its element. We looked at Dodge & Cox's portfolios and communications with shareholders during two other periods of economic stagnation: 1990 and 2001. In January 1990, management noted that "In anticipation of a recession, prices of many stocks have already declined substantially [and] are selling at historically low valuations, both on an absolute and a relative basis. The low stock prices reflect low investor expectations…" The fund's largest sector exposure? Financial stocks, all of which had been creamed by a credit crunch resulting from the collapse in junk bonds. The following year rewarded investors as financials bounced back. At the end of 2001, with the post tech-bubble decline underway and with the worst still ahead, the U.S. economy was teetering toward recession. The S&P had declined 11.9%, but Dodge & Cox had enjoyed a 9.3% gain, the result in part of modest exposure to hot tech (at the start of 2001, 8% of the fund was in tech versus 20% of the S&P 500) and an overweighting in energy. Beyond slight exposure, what the fund owned was relatively neglected old technology names that were cheap in valuation and that suffered as a group only a moderate decline, while the dominant S&P tech names lost 25% of their market cap.

DODGX NOW

2007 was unusual, not because of underperforming the S&P 500. That happens to a fund that stays out of step with the market. Rather, what makes 2007 unusual is the portfolio's pace of change. When we first described DODGX in 2002, the turnover ratio, that is the percentage of positions that were replaced over the year, was 10.3%. Over the next four years, the ratio was never higher than 14% (2004) and averaged 10.1%. Last year turnover hit 27%, an indication the fund managers believed that the market presented serious disparities in value, which means opportunities. The last time turnover spiked at DODGX was in 2000 (32%), which set the fund up for extraordinary gains.

Don't assume the Dodge & Cox management committee went bonkers last year. The committee even as turnover spiked at 27% are a steady bunch. According to *Morningstar*, last year the average domestic large cap value fund had a 58% turnover ratio. The average domestic stock fund had an 86% turnover ratio. Think of Dodge & Cox as a turtle, albeit a turtle now in track shoes.

Twenty new names were added during 2007, two were taken private and 16 deleted. The three biggest additions, all wounded by events, were Novartis (valued at the end of 2007 at $1.6 billion/2.5% of the portfolio), **American International Group** ($1.5 billion/1.8%) and The Travelers Companies ($1.1 billion/1.8%). Novartis took charges for a restructuring; AIG and Travelers are both caught up in the meltdowns in financials. During 2007, the three shares had dropped on average 11% with AIG the most damaged (-17%)

The biggest additions to existing position during 2007 occurred in **Comcast** (+129% in shares), which declined sharply (-35%) along with other cable providers as investors, who anticipated finally starting to see earnings perk up after years of capital expenditures, were disappointed to find even more cap-ex ahead. GlaxoSmithKline (+114%) stumbled on concerns over its asthma drug (Advair) and diabetes drug (Avandia), Liberty Interactive-A Shares (+97%), which derives much of its revenue from the TV-shopping channel QVC, has investors worried about shrinking discretionary spending and also is in the midst of a battle between John Malone, its founder, and Barry Diller, who partners in several properties with LINTA, Wachovia

Corp (+92%) and Capital One Financial (+69%) were victims of the financial sector meltdown. Over the year, the five shares fell on average 25%. The overlap of new positions and expanded positions in sectors such as in financial services stocks and pharmaceuticals suggests where management senses the best opportunities.

DODGX Price Ratios

	P/E (forward)	P/CF	P/S	P/BK
DODGX	12.3	7.6	1.0	1.7
Average Large Cap Value Fund	13.7	8.4	1.3	1.9
Average Mid Cap Value Fund	12.7	6.7	0.9	1.7
S&P	14.3	9.9	1.4	2.4

If we step back from individual positions and look at broader sector allocations, we find that the fund has overweighted two sectors: consumer discretionary and healthcare. From a macroeconomic perspective, one runs against the tide and other runs with it. That is, with consumers anxious right now about their financial security, expecting them to spend on things that can be put off to another day is probably a mistake. Healthcare, something that is not easily postponed, is a traditional safe harbor in hard times.

Though we can discern themes in the portfolio, themes do not drive stock selection. Instead, any storyline emerges from the individual choices made. Consider Consumer Discretionary, the portfolio's largest component (21.6% vs. 8.5% of the S&P): more than half are media companies such as **Time Warner, Comcast** and News Corp, all of which the market considers suspect. DODGX isn't troubled by that suspicion. "With media and cable TV companies now trading at historically low multiples of cash flow and earnings, we remain optimistic about the long-term prospects for these holdings in the Fund."

As for healthcare, large purchases of shares in pharmaceutical companies that have stumbled, and which are cheaper today in terms not just of share price, the least significant metric, but in terms of price ratios, suggests opportunities beyond today's challenges. Management believes that "Concerns over patent expirations and regulatory factors have driven valuations down to some of their lowest levels in 15 years relative to the market. We believe that drug development and technological innovation in biosciences will continue longer term, while growth in the developing world is creating new consumers." Dodge & Cox has the instinct, essential to all value investors, to look backward at historical valuations and forward to restoration of sales and earnings when the market, which is an amnesiac and without a sense of balance, knows only now.

WHAT TO EXPECT

We're all familiar with standard financial fund boilerplate about past performance not being indicative of future results, though many funds prefer you just presume their good years guarantee more of the same. In Dodge & Cox's case, it's more than boilerplate. In the third-quarter letter to shareholders, management observes: "we do not expect the Fund's dramatic outperformance of the S&P 500 (14.3% versus 2.2% annualized, since June 30, 2000) to be repeated." That cold-eyed view recognizes the gross distortions the market demonstrated at the start of 2000 when tech was everything. Dodge & Cox avoided the overpriced and gathered the underpriced. As value-oriented stocks enjoyed a great run after 2000, it is unrealistic to expect a continual stream of similar opportunities. Still, the fund now sees more reason to reposition itself than it has since the start of the decade.

The chart at the top of the page shows that the portfolio's profile remains significantly undervalued, and, we expect, should perform in line with the fund's historical returns. What is a more realistic expectation? In our 2002 recommendation, we compared the performance of DODGX with the Vanguard 500 Index Fund, the first widely marketed S&P index fund and arguably the most successful, that debuted on August 31, 1976, 11 years after Dodge & Cox launched DODGX. Over the next 26 years, Dodge & Cox Stock Fund outperformed the Vanguard bellwether by 2.63% annually. Since then, it has done even better. Thanks to the beauty of compounding, the Dodge & Cox fund ran rings around the Vanguard index fund.

We believe that DODGX based on its long-term performance can continue over the long-term to provide a 2% premium over its benchmark, the S&P 500. Given that currently DODGX holds positions in 14 companies also in the *Sound Advice* portfolio, the fund shares our attitudes and instincts when it comes to value investing. Furthermore, Dodge & Cox has bested its peers and done it cheaply. The expense ratio, which currently stands at 0.52%, is rock bottom for a managed fund. If you are a value investor—or if you simply seek above-average returns—Dodge & Cox Stock Fund offers a time-tested, steady way to address a market that always rewards, at least eventually rewards, investors who buy what is inexpensive. ***SA***

Portfolio Updates

The market worsened as problems that have been pressing stock prices for months accelerated. The dollar keeps on slipping, the economy keeps on slowing, energy prices keep on rising and evidence of inflation is becoming so obvious that Washington itself is beginning to concede that there is a problem. Whether we are in recession or just, as the White House insists, a slowdown, is immaterial. Right now, our economy is gasping for air, and the market, looking ahead, does not see an end.

Consequently, since the last letter, the Dow is down 2.4%, the S&P 500 2.9% and the Nasdaq 4%. As for the *Sound Advice* portfolio, our positions declined 0.53%, which amounts to relative outperformance but is hardly something that makes us proud. When **The Prudent Bear Fund** is among your best performers at +4.5%, you don't need to know much more. If your investments are outside companies that wrest what they sell from the earth, with few exceptions, you lost serious money last month. It was all energy, metals and other commodities.

Though we have been beating the commodity drum for years, and with special urgency over the last year, it still is discouraging to see other situations, which today are just as compelling as were commodities in 2002, languish or get crushed. Ground zero for pain continued to be the financials.

DWS RREEF REIT Fund II, the February recommendation, fell along with financials, dropping 11%. REITs, as was explained in the February letter, are suffering as capital as well as appetite for expansion dries up. But closed-end funds like SRO are being hit by a special problem: the seizing up of auctions at which the rates paid for preferred shares are set. SRO, like many closed-end funds, borrows to buy additional dividend-yielding securities to boost dividends. Provided the interest paid for these borrowed funds is less than the yield from securities purchased, the borrower gains added yield, or, in financial lingo, enjoys a "positive carry." Almost all closed-end funds—and many other institutions—rely on adjustable rate preferred shares (ARPs) for short-term borrowing. Under normal circumstances, rates are reset weekly through an auction process, which borrowers use to rollover their funding. Lately, ARP auctions have failed to attract sufficient bidders, something that was not part of most investors' expectations. In such cases, borrowers pay a default rate, which has meant for SRO a 5.5% rate, a

We Are Replacing Our Gold Fund

American Century Global Gold Fund (BGEIX) effectively has closed and is being replaced in our portfolio by USAA Precious Metals and Minerals Fund (USAGX), a no-load managed fund with an admirable track record. Shareholders in BGEIX (or any American Century fund) prior to 9/28/2007, the closure date, can continue to buy shares in the no-load version. Everyone else will have to buy shares through financial advisors. A load will be attached. Our practice is not to continue to include funds closed to new investors or available only through an advisor.

Since *Sound Advice*'s views on gold as a hedge against inflation and a weak dollar should be well-known to you by now, rather than devote the next issue to establishing why the replacement fund is worth your consideration, we will offer only a brief description of why we have selected this fund.

As the fund's name shows, USAGX can own non-precious metals, one reason it has racked up one of the best returns among all natural resource mutual funds. Unlike BGEIX, it does not use a proprietary index to shape its portfolio. Instead it relies on the discipline of its manager, Mark Johnson, who has steered the fund since 1994. His portfolio lately has benefited from owning mid-cap gold miners with low gold costs. The fund itself is one of the oldest metals funds, having debuted in 1984. We have owned USAA funds in the past, and admire them.

As of its last SEC report, the fund is 76.4% in gold, 8.9% in platinum, 3.5% in silver, and 6.4% in base metals. The inclusion of metals miners such as Freeport-MacMoran, which acquired copper miner Phelps Dodge last year and became a bi-metal producer of both gold and copper, adds some stability to the fund's volatile golden rudder.

(continued on page 9)

Sound Advice Portfolio for March 2008

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
DWS RREEF Real Estate Fund II	SRO	AMEX	$11.79	14.96%	**$14.00**	BUY
HRPT Properties	HRP	NYSE	$6.69	12.56%	**$8.00**	BUY
Diversified Growth					.	
Agrium	AGU	NYSE/TSE	$71.55	0.15%	$75.00	BUY
American International	AIG	NYSE	$42.88	1.87%	**$50.00**	BUY
Boston Scientific	BSX	NYSE	$12.35	0.00%	$16.00	BUY
Coca-Cola Enterprises	CCE	NYSE	$24.17	0.99%	$28.00	BUY
Disney	DIS	NYSE	$30.76	1.01%	$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	$40.63	6.80%	N/A	BUY
Dodge & Cox Stock Fund	**DODGX**	**800-621-3979**	**$121.83**	**10.88%**	**N/A**	**BUY**
Excelsior Value & Restructuring	UMBIX	800-345-6611	$51.80	1.60%	N/A	BUY
Fastenal	FAST	NASDAQ	$39.27	1.17%	$45.00	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	$12.74	0.31%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	$23.01	1.01%	N/A	BUY
Honeywell	HON	NYSE	$56.56	1.77%	$64.00	BUY
Insituform Technologies	INSU	NASDAQ	$13.09	0.00%	$16.00	BUY
Johnson & Johnson	JNJ	NYSE	$61.51	2.70%	$73.00	BUY
Liberty Capital****	LCAPA	NASDAQ	$16.44	0.00%	**$20.00**	BUY
Mattel	MAT	NYSE	$19.38	3.87%	$25.00	BUY
Microsoft	MSFT	NASDAQ	$27.87	1.58%	$36.00	BUY
Molson Coors Brewing	TAP	NYSE	$50.57	1.62%	$59.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	$8.77	0.00%	$11.00	BUY
Sara Lee	SLE	NYSE	$12.49	3.36%	**$15.00**	BUY
Schering-Plough	SGP	NYSE	$19.75	1.11%	$26.00	BUY
Sony	SNE	NYSE	$44.32	0.49%	$55.00	BUY
Sprint Nextel	S	NYSE	$7.01	1.43%	**$10.00**	BUY
Superior Industries	SUP	NYSE	$18.05	3.55%	$20.00	BUY
Tetra Tech	TTEK	NASDAQ	$17.32	0.00%	$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	$52.92	3.95%	N/A	BUY
United Parcel	UPS	NYSE	$71.96	2.33%	$76.00	BUY
Wal-Mart Stores	WMT	NYSE	$49.90	1.34%	$55.00	BUY
Whole Foods Markets	WFMI	NASDAQ	$34.07	2.11%	$45.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	$50.38	3.16%	N/A	BUY
Xerox	XRX	NYSE	$13.87	1.15%	$19.00	BUY
Energy/Natural Resources						
American Cent. Gold Fund	BGEIX	800-826-8323	$26.15	0.42%	N/A	**SELL**
Anglo-American PLC	AAUK	NASDAQ	$32.78	3.45%	$36.00	BUY
EnCana	ECA	NYSE/TSE	$76.91	1.04%	$75.00	BUY
Icon Energy Fund	ICENX	800-764-0442	$29.67	32.97%	N/A	BUY
Plum Creek Timber	PCL	NYSE	$39.48	4.26%	$50.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	$68.82	4.18%	$87.00	BUY
Transocean	RIG	NYSE	$136.31	24.45%***	$150.00	BUY
USAA Precious Metals & Minerals	**USAGX**	**800-862-6909**	**$38.60**	**6.87%**	**N/A**	**BUY**
Aggressive Growth						
Comcast	CMCSA	NASDAQ	$19.67	0.00%	$22.00	BUY
Discovery Holdings	DISCA	Nasdaq	$20.80	0.00%	$33.00	BUY
Electronic Data Systems	EDS	NYSE	$16.71	1.20%	$24.00	BUY
Ford Motor Convertible Pfrd.	F.PRS	NYSE	$30.72	10.58%	$41.00	BUY
Getty Images	GYI	GYI	$31.90	0.00%	N/A	**SELL**
Icon Financial Fund	ICFSX	800-764-0442	$9.88	16.90%	N/A	BUY
Liberty Entertainment****	LMDIA	NASDAQ	$25.40	0.00%	$29.00	BUY
Liberty Global	LBTYA	NASDAQ	$36.70	0.00%	$45.00	BUY
Maxim Integrated	MXIM.PK	NASDAQ	$18.30	1.89%	**$23.00**	BUY
The Prudent Bear Fund	BEARX	800-711-1848	$6.92	2.89%	N/A	BUY
Symantec	SYMC	NASDAQ	$16.94	0.00%	$20.00	BUY
Time Warner	TWX	NYSE	$14.86	1.48%	$20.00	BUY
Western Digital	WDC	NYSE	$30.28	0.00%	**$33.00**	BUY

Prices as of the market close on Friday, March 7, 2008

****Yield represents all distributions (income and capital gains) during previous 12 months divided by current share price. Note that all fund distributions fluctuate annually.***

*****Yield reflects one-time special distribution.***

******Liberty Capital is being partitioned into two tracking stocks: LCAPA and LMEDIA. See Page 7 for details.***

BUY, HOLD, SELL OR LIMIT IN BOLD SIGNALS CHANGE IN ACTION OR LIMIT significant increase from the 4% it was paying before the ARP market went to hell. However, 5.5% is roughly where rates stood several months ago, and, because SRO's auction contracts allow for only a small premium for the default rate, are a far cry from some of the truly grotesque default rates being paid elsewhere. The carry remains positive, that is, at current rates SRO is making a positive return from shares bought with ARP-generated funds.

The **Icon Financial Fund** matched SRO, dropping 10.7%. We cannot recall U.S. credit markets ever being this irrational. Read Marty Whitman's comments on Page 2 about how accounting rules are forcing companies to take phantom write-offs.

American International Group, whose woes we outline on Page 2, fell 15%.Current prices, a result of the dysfunctional market, are as big a bargain as we see among large cap companies. **HRP Properties Trust** dropped 16.7%, worse than most REITs, as management conceded that should the market for office properties remain stagnant for the next two or three years, a cut in the dividend might be considered then. We're willing to buy shares at the current price, which translates into a 12.6% yield. The last time HRP sported this big a yield was the bottom for REITs back in mid-2000.

Make no mistake, credit markets today are as bad as we can remember—not that they could not get worse. Consider the plight of companies like Thornburg Mortgage (not in our portfolio), a REIT that holds primarily gilt-edged jumbo residential mortgages, and finds itself on the brink of insolvency not because its mortgagees are in default but because the lenders from whom Thornburg itself borrows to finance its portfolio of mortgages are demanding payments as the collateral they hold, Thornburg's own portfolio of mortgages, is falling in price not because homeowners are not making payments but because the market for mortgages is dead. As one observer puts it, [Thornburg's] creditors have "no place to sell these securities, and so it's forcing them to shoot their customers…'Thornburg is an unfortunate victim." Price and value have parted ways.

Having said that it was only commodities that prospered this month, let's look at some positive exceptions: **Getty Images** is going private, and added 19.8%. We are selling it now. **Comcast**, which last year along with the other cable companies swooned, is being accumulated, added 15.3%. **Western Digital** moved up 7.4% as investors begin to appreciate the virtues of old tech and how it plays a role in both new entertainment gizmos and computers. **Wal-Mart** reported better sales, adding 2.3% as strapped shoppers sought everyday low prices for essentials and somewhat paradoxically consumer electronics. **Sony** also prospered, in part thanks to its besting Toshiba in setting the tech standard for the next generation of DVD players. SNE added 3.1%. Beverages worked fine: **Molson Coors** came in with good numbers and jumped 12.4%, while **Coca Cola Enterprises** added 3.8%.

Note that **Liberty Capital**, a tracking stock created by **Liberty Media**, has been subdivided through a second tracking stock, **Liberty Entertainment (LMDIA—Nasdaq)**, which tracks Liberty's holdings of DirecTV, Starz and numerous other properties. Each old LCAPA share is now one new LCAPA share and four shares of LMDIA. Once you tote up the prices, the new package of trackers is up 8.5% from last month.

Aside from the REIT fund and Icon Financial Fund, prominent pain hit **Sprint Nextel**, which said it was writing off essentially all of the "goodwill" booked when it acquired Nextel. We hope that this accounting bath represents the low point for the combination that has turned out far worse than we expected. Nonetheless, the assets here remain attractive, and we'll wait to see how the new CEO realizes their value. Sprint Nextel remains the only independent national cell network. S lost 25% of its share price since the last letter.

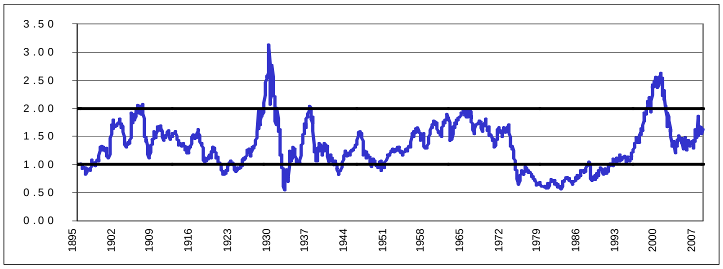
Sectors that suffered less trauma included healthcare: **Schering-Plough** and **Boston Scientific** were up less than 1%, and **Johnson & Johnson** was flat. Thanks to the humbled dollar, international stocks were up fractionally, which was good news for **Fidelity Japan Fund** and **Dodge & Cox International Fund**. DODFX announced it would now hedge its foreign currency exposure, a change that bears watching, since it suggests Dodge & Cox believes the dollar's demise is nearing its end.

As for those commodities, it was up, up and away: **Agrium**, the fertilizer maker, jumped 16.5%; **EnCana** 14.3% as the price for natural gas starts to close the gap with oil; **Anglo American** added 12.9% as copper, coal, iron and pretty much everything it mines run toward all-time highs; **American Century Global Gold Fund** rose 10.2%. See 7 for important information on this fund. **Transocean** is up 8.9%. Exxon Mobil announced it was raising its capital expenditures to $25 billion, a 20% increase. XOM last year replaced only 76% of the oil it lifted.Expect this to benefit RIG in particular. **Icon Energy Fund** is up 4.2%. The laggard was **Royal Dutch** up only 1.6%. If you are looking for a big energy company for your portfolio, this one is cheap. ***SA***

Sound Advice Market Indicators for March 2008

The Diffusion Index of Lagging Indicators gives “Sell” signals when all 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. Currently 25 percent of the indicators is above its level of six months earlier.

The Diffusion Index of Leading Indicators gives “Buy” signals when its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates. The latest reading came in December 2005 as a "Buy". Currently 100 percent of the indicators are above their level of six months earlier.



The Risk Indicator tracks supercycles in stocks by comparing prices of stocks to real estate (house prices). A reading above 2.0 indicates times when stocks are extremely high relative to real estate. These are times when the risk is high and a supercycle is approaching a zenith. Conversely, a reading below 1.0 indicates stock prices are extremely low relative to real estate. At these times, the upward phase of a new supercycle is beginning. The current reading stands at 1.64.

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. Between each “Buy" signal and each “Sell" signal, the S&P 500 rose substantially without exception. The average gain was 30.08 percent, not counting dividends. On an annualized basis the gain was 16.3 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

Buy Signals		Sell Signals	
Date	**S&P 500**	**Date**	**S&P 500**
		Feb-69	101.50
Sep-69	94.51	May-73	107.20
Nov-74	71.74	Aug-77	97.75
Jan-81	132.97	Dec-83	164.36
Sep-85	184.06	Oct-87	280.16
Mar-89	280.00	Sep-89	347.33
Oct-92	415.10	Jan-95	464.72
Feb-97	798.38	Sep-99	1,383.60
Feb-03	841.15	Jul-05	1,234.18
Dec-05	1,248.29		

During the intervening periods between “Sell" signals and “Buy" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased a paltry 0.8 percent per year, a return that could have easily been beaten many times over with safe investments such as Treasuries, short-term bonds or other low-risk investments.

To assess whether a market crash is likely after a "Sell" signal, we turn to the Risk Indicator. If the Risk Indicator is close to or above 2.0, we know the market is relatively high and contains a high degree of risk. This was indeed the case in September 1999 when the Diffusion Index of Lagging Indicators flashed a “Sell" signal and the Risk Indicator was (substantially) above 2.0. The peak came in six months, marking the end of the bull market as well as the peak of Supercycle Five. The market subsequently crashed. The S&P 500 dropped 39 percent until the next “Buy" Signal was given by the Diffusion Index of Leading Indicators in February 2003 (which was the exact month that bear market low point was reached). During that decline, most stocks suffered greater losses. The NASDAQ dropped nearly 80%.

Conversely, the market does not suffer lasting declines after “Sell" signals when the risk level is low. For example, the “Buy Signal” in November 1974 was one month from the bottom of that bear market, and came at a time when the Risk Indicator was below 1.0. Consequently, this “Buy" signal also marked the beginning of Supercycle Five. As the upward phase of Supercycle Five ensued and the Risk Indicator remained relatively low, the market did not experience lasting downturns after “Sell" signals. Instead, the bull run was merely interrupted with short declines, sideways movements, and sometimes even advances. Even the three-day decline in October of 1987, which became known as the “Crash of 87”, was followed by a stampede of buyers snapping up bargains. I remember seeing individual investors lined up to invest outside discount brokerage offices because the phones were log-jammed with buyers.

However, as previously noted, when Supercycle Five reached its peak and the Risk Indicator climbed above 2.0, the decline was severe after the September 1999 “Sell" signal due to the excessive heights to which prices had previously been propelled.

We use the ***Sound Advice*** Market Indicators to influence our approach and nature of our recommendations. When “sell” signals are in force, our recommendations are more defensive in nature. We will be looking for special situations and are likely to recommend taking profits more readily. Conversely, during “buy” signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market averages (more than double the profits from the S&P 500 since 1/1/2000). ***SA***

YOUR CHOICE: A GREAT DEAL OR THE BEST DEAL

GREAT DEAL: 12 Month Renewal. A $254 value for only $99!

Panic-Proof Investing
in the
Stock Market
By Gray Emerson Cardiff

The **2007 edition of** ***A Millionaire's Guide to Panic Proof Investing***. This is the book that explains all of the *Sound Advice* indicators, including the Diffusion Indexes and the famous Risk Indicator, and exactly how they work so that you can update them yourself.

SOUND ADVICE
THE CHINA Backlash

The China Backlash A $29.95 Value...**YOURS FREE**. The rapid expansion of the Chinese economy has created a ticking bomb. This report explains the key factors of the Chinese expansion and how they are connected to an unavoidable backlash that will impact all of our investments.

This is a great deal. Even forgetting about the Special Reports, *Sound Advice* will cost you less than 25 cents a day — less than a cup of coffee. But wait, it can get even better if you take me up on my...

BEST DEAL! 24 Month Renewal. A $522 value for only $165!

You'll receive the Book and China Backlash Report shown above, PLUS ...

A Gift (or Extension) of Sound Advice**.** Here is a 6-month gift subscription of *Sound Advice*. And it includes all of the introductory special reports that you received initially when you subscribed, including the **2007 edition of** ***A Millionaire's Guide to Panic Proof Investing***. **You can also give this gift to yourself.** It will extend your renewal by 6 months, absolutely FREE.

SOUND ADVICE
THE *SOUND ADVICE* SPECIAL SITUATIONS

The Sound Advice Special Situations A $29.95 Value…**YOURS FREE**. Here is a complete update of each stock and mutual fund in the *Sound Advice* model portfollio. We review the fundamentals of each recommendation, why they are special situations, and what we expect for the future. This will give you a chance to review your investments along side our recommendations, and make sure your money is working the hardest it can for your future.

If you take the **BEST DEAL**, you will receive *Sound Advice* for only 16.3 cents a day. You can't buy anything for that. But whether you take the Great Deal or the Best Deal, you will receive wealth-building advice that you can take advantage of on your own through no-load funds or discount brokers. The commission savings alone will pay for your subscription many times over, not to mention the astonishing and reliable profits I am confident you will reap, along with inflation-proofed high income. Join me in helping you dramatically increase your wealth safely in the new bull markets starting right now.

E-Subscribers Get 6 Months FREE!

Regardless of your choice, you can add 6 months to your renewal, absolutely FREE.
Go to WWW.Soundadvice-newsletter.com and click on "Renew".
To fax or mail in your renewal, see the coupon on the reverse side.

To fax or mail in your renewal, please fill out the coupon below.

(or go to www.Soundadvice-newsletter.com and click on "Renew".)

Sound Advice / 939 Hartz Way/ Suite 210 / Danville, CA 94526 /800-866-0026/Fax925-838-0522

□ **BEST DEAL! 24 Month Renewal. A $522 value for only $165! You will receive ALL of the Special Reports listed on the reverse side as well as the 6 Month Gift Subscription package.**

□ **GREAT DEAL: 12 Month Renewal. A $254 value for only $99! You will receive, both of the Special Reports listed on the reverse side.**

□ **WITH MY 24 MONTH RENEWAL, SEND MY FREE 6 MONTH GIFT SUBSCRIPTION TO:**
(Write "To Me" to extend your own subscription.)

Name ______________________________________

Address_____________________________________

City______________________ State_____ Zip_________

Phone (_______)_________-______________________
(In case we have a question about the order)

□ Enclosed please find my check payable to: ***Sound Advice***

□ Please charge my: □ Visa □ MasterCard: Card #: ____

Expiration Date:___________ Security Code _______________ (the 3-4 Digit Number on the back of your credit card)

Daytime Phone # _______-_______-______________________ (in case there is a question about your order):

E-mail Address: ____
(For important news and updates between Issues)

E-Subscribers Get 6 Months FREE!

Regardless of your choice, you can add 6 months to your renewal, absolutely FREE!

□ **Yes!** Add 6 months to my choice above and E-mail me my issues. My E-mail address is above.

(tear along perforated dotted line)

Enclosed: the March Issue of *Sound Advice* for...

NEXT ISSUE MAILS ON APRIL 11TH

Sound Advice
939 Hartz Way
Suite 210
Danville, CA 94526

Address Service Requested

First Class Presort
US Postage
PAID
Permit #185
Sacramento CA