Gray Cardiff's

SOUND ADVICE

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If you think that a slowdown or recession is an unmitigated disaster, think again. If you are a buyer, opportunities abound for big-ticket items. Last month, a colleague bought a new car. It took longer to sign the paperwork than to agree on a price. The dealer dropped the price below invoice; the manufacturer expanded rebates to $1500 and added zero-financing. It helped that my colleague had done his homework on the Internet, and had left his wife at home so he didn't need to debate cup holders and colors.

This month's recommendation, CarMax, a national chain of used-car stores, is hurting, and is cutting deals to move inventory. It also must worry about the SUVs and other gas guzzlers already in inventory that no one now wants with gas approaching $4 a gallon. Those will sell at some price that will be a drain on the income statement.

This is, we think, a fine moment to be shopping for car stocks and, for that matter, any company whose sales and earnings are suffering due to a depressed economy. If you are a veteran *Sound Advice* subscriber, this makes sense to you. If you are new to the letter, giving us a test drive so to speak, understand that we invest in the belief that the market is not efficient, especially at extremes. At extremes it does a terrible job at valuing companies whose shares are under stress whether from fear that the company will wither, or from greed that if you don't grab shares, they will rocket out of reach, and you will have missed making a killing. We are always looking for such opportunities to buy other people's pessimism.

--Gray Emerson Cardiff

Hitting for the Cycle

The yes-it-is/no-it-isn't game politicians play with whether we are in recession or not is worthless. You won't find a Republican official who opines we are in recession. You won't find a Democrat who denies it. What makes this difference of opinion laughable is that despite politicians' willingness to pat themselves on the back when the economy is flourishing, they really have modest influence on the economy's expansion and contraction. To adapt a tag line from Bill Clinton's campaign: "It's the business cycle stupid."

Only in retrospect do we get to discover whether we are now in recession, and, if we are, only in retrospect do we recognize when it has ended. The National Bureau of Economic Research is the recognized authority for declaring when recessions begin and end. But on average the NBER needs about six months to detect the start of a recession, and a stunning 15 months to realize a recession has ended. This can create just a bit of confusion.

For example, on November 26, 2001, the NBER announced that in March of that year, eight months earlier, the U.S. economy had gone into recession. On July 17, 2002, the NBER announced that the recession had ended in November 2001. Think about that: the very month the NBER recognized we had been in recession for eight months turned out to be the month NBER eight months later determined that the recession had ended.

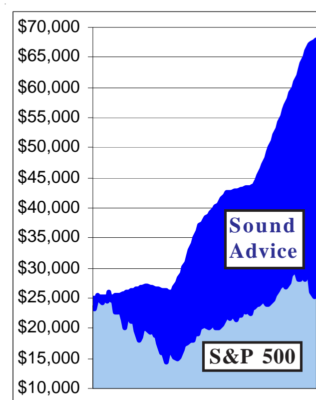
Many market observers believe equities pick up about five or six months before the economy itself provides evidence of recovery. But in the last recession, the market was no prophet. Regardless of whether you stepped into the market six months before the recession ended, or entered on the

Sound Advice

Annual Returns

24.6% Since 1-1-06
21.3% Since 1-1-03
13.6% Since 1-1-00

Versus the S&P 500



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

$26,836 with the S&P 500

$71,999 with *Sound Advice***

= 25 Times More Profits

S&P 500 Returns During and After a Recession

Date NBER Selects For Recession End	Total Upmove from Bottom to High	Bought Six Months Before Recession Ended	Bought Just as Recession Ends	Bought When NBER Sees Recession Had Ended
11/15/2001	101.50%	25.31%	36.43%	72.75%
3/15/1991	416.98%	403.73%	308.86%	243.78%
11/15/1982	68.57%	46.30%	25.99%	3.33%
7/15/1980	43.07%	26.14%	17.79%	9.51%
3/15/1975	72.38%	50.42%	26.78%	5.91%*
11/15/1970	93.03%	56.36%	42.89%	11.59%*
2/15/1961	132.59%	101.38%	76.46%	-29.83%

*NBER began dating recessions in 1980. For pre-1980, we've fabricated the "announcement date" by adding the average lag (15 months) to when NBER says the recession did end.

day the recession ended, or even waited for the NBER to declare the recession had ended , you would have lost money while waiting for the market to turn: 38% had you entered six months before the economy emerged from recession, 32% had you bought the S&P 500 just as the recession ended, or 14% had you bought on November 26, 2001, the day the NBER announced the recession had ended. The S&P did not bottom until October 9, 2002 at 776.8, nearly a year after the NBER all-clear declaration. In short, had you relied on the NBER during the last recession, you would have taken further punishment before the market turned upward.

There are no guarantees in investing, just likelihoods. There is no way to nail inflection points in the market. But there do seem to be ways to get closer, and that involves investing when the economy is sick. In fact, the matchup of the 2000-2003 market decline and the 2001-2002 recession is an exception. If we look at the previous six recessions (1960-61, 1969-70, 1973-75, 1980, 1981-82, and 1990-91), anyone who bought either just as the recession ended or, better yet, six months before, would have reaped superior returns.

As for *Sound Advice*, our timing model, which also takes its cues from economic numbers, has been helpful during recessions, even during the 2000-2003 bear market. We flashed a sell signal in September 1999 and a buy signal in February 2003. Furthermore, when the economy sours, we don't particularly care whether it is or is not technically in recession. Our indicators put us into the market six months after they detect slowing, and lead us to more defensive positions six months after they detect an overheating economy. We try to take advantage of Mr. Market's pessimism discount when there is evidence of economic weakness and his optimism premium when there is evidence of boom. Invariably this makes us seem out of touch with the market's mood. That's fine with us, since we want to be out of synch with what other investors are doing .

HITTING FOR THE CYCLE

If the market does pick up in advance of the economy, should investors during economic slowdowns simply get long by buying broad-based index funds or ETFs? That would be reasonable. However, we prefer a rifle rather than a shotgun when hunting for profits. Instead of just buying the market, we think we can isolate sectors that at this point will respond to a recovering economy, that are "early cycle" stocks, that is sectors that historically lead the economy out of slowdowns.

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Should You Buy a Used-Car Company?

Sound Advice this year has been recommending financials and real estate, neither of which is out of danger but offer reward enough to justify the risk. This month we want to take another contrarian step into a sector that also suffers in a slowing economy, consumer discretionary stocks. **CarMax (KMX—NYSE)**, the biggest used-auto seller in the United States, not only is trading down in a stagnant or worse economy but also has drawn some interesting fans over the last few months. With gas prices and consumer confidence moving in opposite directions, recovery for CarMax calls for not just a change in consumer confidence but also a positive resolution of the same credit issues harming the financial sector, since this company depends on lenders to finance its vehicle financing and on big financial companies to securitize its bundled car loans and institutional buyers to acquire them. Hence, CarMax is as much a credit market story as it is a consumer recovery story. For the moment, all CarMax can do is continue to build a used-car juggernaut despite a hostile economic environment. As the economy resumes growth (hard to imagine right now, isn't it?), we think the shares can double.

CARMAX

Circuit City, the big-box electronics retailer in 1993 test marketed the CarMax concept with a single store in Richmond, Virginia. Today CarMax operates 90 used-car superstores and a handful of new car dealerships concentrated in the South. A quarter of its stores are in Florida and Texas. In 1997, Circuit City created a tracking stock for its used-car business, and spun the subsidiary off to shareholders as a special dividend in 2002.

The parent and child have been very different experiences for investors. Though over the first few years Circuit City poured money into getting the business going, after the shares were spun off KMX has handily outperformed its creator. Since CarMax began to trade, its shares are up 165% while Circuit City has lost more than half its share price. Over the last two years, that divergence has widened. KMX, even after getting knocked down as the economy tanked, is up 22%. Circuit City is down 81%. CarMax today has a market cap of $4.3 billion. Circuit City, bloated with its 671 superstores, has dwindled to $834 million in market cap.

Circuit City's rise and fall offer a roadmap for why CarMax could enjoy big-time growth in terms of profits and share price. In its youth and middle-years, Circuit City dominated the home electronics sector and expanded nationally with relatively little competition. But, like many retailers goaded by Wall Street to keep expanding revenues, they overstored themselves to death. At the same time, Circuit City saw new, more efficient competitors like Best Buy grab customers.

CarMax, despite the used-car business having been around forever, is just starting to scratch the surface of its potential market. It is where Circuit City was when its shares took off. For the foreseeable future, CarMax has no worry about oversaturating its market. Not only is KMX, like Circuit City once did, addressing nationally what had been a highly fragmented, local business, it also has developed a solid business model that provides advantages over its competitors, and enjoys nice margins. CarMax is by far the biggest seller of used vehicles in the U.S. Yet it controls a mere 2% of usaed-car sales that last year totaled $300 billion. Prospects for future growth are wide open.

CARMAX BUSINESS MODEL

Though many assume that used-car transactions for new car dealers exist to facilitate the sale of new vehicles, the fact is that CarMax has filleted out what is the highest margin part of auto sales. A friend, retired from running new car dealerships, confides that even in the 1980s and 1990s when dealers still held the stronger hand because competition was not as cutthroat and consumers did not have access to pricing data now available on the Internet, service and used-car sales were his profit makers. Today, during a downturn in new car sales, dealers depend on used-car sales to stay in business.

Unlike independent used-car lots or those yoked to new car dealerships, CarMax has developed extraordinary tools and techniques for exploiting this most lucrative part of the retail auto business. CarMax's internet site (www.carmax.com) allows potential buyers to scan the entire national inventory, and is chock full of helpful tools and tutorials to make the car buying experience easier. The company gauges that 41% of sales begin with a customer's visit to the site.

Sure, there are other online used-car sites like Vehix.com that advertise anyone's car for sale, but CarMax also has centralized the cars at their local lots. For a visitor to the Vehix site, getting a hit means driving all over the county to check them out. For example, seeking Toyota Camrys within 25 miles of my home, Vehix.com produced nine hits. Five are at three different locations, and another four, none of them with prices, are at two other locations. On the CarMax site, eight Camrys are at the nearest CarMax store, and another 10 are at the second closest store. CarMax is willing to transfer any of them at no charge to the Modesto location to make the sale. CarMax also cross-lists its cars on broad-based sites such as autos.com.

Vehicles on CarMax lots are under six years old and have fewer than 60,000 miles on the odometer. The average CarMax used-car sells for around $16,000. CarMax offers clearly stated fixed prices for the 250 to 400 vehicles on each superstore's lot.

There is no haggling, which suits most shoppers. Because CarMax pays its sales force a flat dollar amount commission for each vehicle sold rather than rewarding them for moving vehicles with the highest profit margin, sales people can concentrate on matching the buyer to what the buyer wants, not what generates a bigger commission. CarMax boasts it avoids hiring veteran car salesmen, since it doesn't want to try to correct bad habits. In fact, CarMax uses popular mistrust of car dealers to its advantage, publishing on its website a "How To Avoid Dealer Pricing Games" (http://www.carmax.com/dyn/research/dealerpricing/games.aspx). Cars are sold with a five-day return policy and a 30-day warranty. Before cars are put up for sale, they are checked and brought up to CarMax standards.

CarMax gets about half its inventory from retail sellers, who either are buying another car from CarMax, or are simply selling the vehicle. The rest come from auctions of better vehicles and from fleet retirements.

CarMax also runs its own auctions to dispose of cars and trucks that do not meet its standards either because they have too many miles, are too old, or have suffered serious damage and been repaired. These auctioned vehicles come from CarMax customers. Last year, excluding auction sales, KMX sold 355,584 vehicles, 95% of them used.

The company historically has expanded its locations at about a 16% annual rate, and expects to add 14 new locations this year. At present, CarMax operates 90 superstores in 41 markets, and six new car dealerships. The latest addition, a satellite store in Charleston, South Carolina, measures 13,000 square feet and stocks between 250 and 350 vehicles. More common are the standard superstores, which are between 40,000 and 60,000 square feet. There are also 13 megastores that are 70,000 to 95,000 square feet and sprawl over 20 to 35 acres.

What has changed is where new stores are being located. Till now, CarMax has expanded its stores from its first Virginia location throughout the Southeast and Midwest. Stores have tended to be put into mid-size urban/suburban markets with an average TV audience between 600,000 and 2.5 million, which lowers the per-person advertising costs. As CarMax pushes outside its home regions, it is also looking at larger media markets. For instance two superstores opened last month in Phoenix, and another will open in Philadelphia. New car dealerships are being whittled down, and now number four.

> **Accept that there is no way to time when the U.S. economy will recover, but when it does, CarMax will prosper. Also, accept that until the market senses such a turn, KMX will be vulnerable.**

CARMAX OPERATIONS

Because most CarMax lots are fairly new (since the end of FY2005, the number of used-car stores has increased by nearly 50%), sales at these are only now reaching their targets, though current economic conditions are slowing that pace. As the CarMax selling model matures and creates return buyers, CarMax should see continued sales growth as new customers compound an established base of satisfied buyers. To underscore its customer friendly model, management suggests that as sales push higher and cost efficiencies cut expenses, much of the savings will be passed on to customers.

CarMax is not the only publicly traded company involved in the used-car market,though only one competitor, America's Car-Mart, has built its business around used cars. At $173.2 million market cap and $257.4 million in revenues, America's Car-Mart is tiny compared to CarMax ($4.5 billion and $8.3 billion). In dollar terms, for the entire market used car sales run about even with new car sales, though in numbers used cars dwarf new cars. CarMax estimates that in 2006, $340 billion were spent on used cars, a bit less than

what was spent on new vehicles. However, for every two new cars sold, five used cars changed hands.

CarMax tries to turn its inventory over eight to 10 times a year. Since it selects cars from local owners either by direct purchase or at auctions, CarMax believes it can shape its inventory to match local preferences . Its buyers must be keenly tuned into local tastes and trends, but because turnover allows CarMax to refresh its inventory, the company does not have to endure the risk new-car dealers face whose inventory remains constant from model year to model year. Imagine having a lot filled with brand new super SUVs today? The company also picks up extra income from selling extended warranty policies underwritten by external insurers. About half of CarMax sales involve such coverage that kicks in after CarMax's own 30-day warranty expires. The most crucial service CarMax provides, however, is financing.

CARMAX REALITY

In a stagnant economy, selling cars hardly prospers. That's why the shares are bargain priced now. In the most recent quarter, KMX reported revenue was up 10%, but same-store sales were flat. Compare this to the previous year's same quarter when revenues rose 19% and same-store sales jumped a stunning 19%. Management notes that while used-car sales declined in price and slowed in number, prices for the older cars CarMax disposes of at auction rose slightly, which suggests there are more buyers for cheaper if less reliable auction vehicles, not the market KMX cultivates.

Though CarMax continues to expand its stores, sales projections for the coming year are contracting. Management estimates same-store-sales growth at 5%, but concedes that it might shrink by as much as 2%. In the previous year, when times were better, same-store sales increased at an 8% unit rate and a 13% dollar rate even after factoring in reduced new car sales.

Share price peaked at just under $30 at the start of last year, before the credit crisis materialized and consumers turned skittish. At the time, the market was bullish. *Value Line* noted that KMX was enjoying strong profit growth and share-price momentum. *Value Line*, which knocked CarMax last fall from being a timely to an out of season investment, is tepid at best about its near-term prospects. As often is the case when *VL* reduces timeliness, the share-price growth target over the next five years has swelled to a possible annual rate of 26%. Nice, if it happens.

FINANCING AND SECURITIZATION

The slowdown in earnings is not just a matter of slower sales. CarMax relies on its financing business both to facilitate sales and also as a core source of profits. In fact, the CarMax Auto Finance (CAF) program is at CarMax's heart. The CAF program plays a part in two out of every five used cars CMX sells. For clients whose credit scores fall below CAF standards, there are two external third-party financing sources, from which KMX receives a fee. CarMax has no recourse liability for vehicles financed by these third-party lenders.

In the most recently reported quarter, CAF brought in half of the revenues from the same quarter last year. Furthermore, borrowing costs for CarMax have risen as lenders,have gotten tough not just on the interest rates they demand but also on the criteria for lending.

CarMax itself is tightening the screws on potential borrowers, using higher credit scores to qualify borrowers and asking for a higher down payment. To move more vehicles, CarMax also is cutting its margins. In the most recent quarter, it chopped $120 off its gross profit per vehicle.

As we have learned during the housing/mortgage debacle, what begins as a slowdown by homebuyers evolves into a spike in foreclosures that expands to the credit markets as bonds and derivatives built out of those loans drop in value, which in turn threatens the solvency of any firm or person who owns them. Despite everything the Federal Reserve has done to stabilize the credit markets, lenders remain hesitant to lend and institutions and individuals who once readily snapped up asset-backed securities(ABS) are hesitant to buy.

CarMax relies on securitizing its financing contracts. Like the mortgage business, car dealers bundle their car loans and sell them as asset backed securities in order to recoup the credit needed to generate more loans. During a period of cheap credit and loose credit standards, the ABS machine purred. Now KMX and other lenders are seeing that machine cough. Floating new securitizations remains possible, though more difficult. CarMax just floated a $742 million program. But clearly issuing ABS is harder. CarMax offered a heftier yield, and must keep on its own books more of the lowest rated credits. To gain the flexibility CarMax needs during tight times, it has expanded its warehouse facility, that is a line of credit that can be drawn down to finance business. That number recently has moved from $1 billion to $1.3 billion.

Those warehoused loans as well as the shakiest ABS can come back to bite the balance sheet and bottom line. Once a car is sold, CarMax books as revenue the "present value of the expected residual cash flows," which means that the company projects the value of that loan based on a complex net of assumptions that include interest rates, the economy and behavior patterns of customers. In short, the same potential for miscalculation exists in this market as it does in housing. Though CarMax is not liable for loans it has securitized, those that are warehoused and others that are retained are vulnerable to repricing should any of the numbers underpinning present value drop.

So far, CarMax has not reported anything comparable to what has occurred with residential real estate loans, but there is reason to be concerned. For example, during the last reported quarter, the percentage of past due accounts in relation to all managed receivables rose to 2.51%. In the 2006 quarter, the ratio was 1.93%. Credit losses also were up from 0.85% of managed receivables to 1.12%. Times are tough.

CONVERTIBLES IN WINTER

As *Value Line* and the share price bear witness, the current environment is unfriendly to CarMax. The tense credit markets only compound the situation for big-ticket retailers like CarMax. Support for the shares has dwindled. You could almost hear growth investors scuttling for the exits during the conference call when management suggested that sales conceivably could decline in the next quarter, a first in the company's history.

However, as growth guys exit, value-oriented buyers are moving in. **Dodge & Cox** during the latter part of 2007 started a position. Even contrarian growth funds are buying shares. And then there is the Buffett factor.

Sometime between June 30 and September 30, 2007, Berkshire Hathaway spent more than $250 million to buy almost 14 million shares. At the end of that period, the shares traded at $20.33. Over the next three months, Berkshire increased its position by almost 50% as KMX share price traded as low as $18.88.

What Buffett looks for sometimes differs from our own criteria. We are more willing to look at dented companies that are not likely to return to their past glory, what Buffett terms "cigarette butt" companies that have perhaps only a puff or two left but are incredibly cheap. Forty years ago, Buffett summarized what he looked for: a business he can understand that has favorable long-term prospects, be operated by competent people, and it must be available at a very attractive price. CarMax fits these criteria. It would be nice to buy shares when KMX is firing on all cylinders, but then the share price would not be so seductive.

Accept that there is no way to time when the U.S. economy will recover, but when it does, CarMax will prosper. Also, accept that until the market senses such a turn, KMX will be vulnerable, though we think that the high teens represents a solid floor for the share price provided nothing disasterous occurs. We recommend buying KMX up to $23. ***SA***

("Hitting for the Cycle," continued)

Not surprisingly, since these companies often have languished or at best underperfomed since the previous business cycle's early phase, they are also often more out of favor (and consequently cheaper) than the rest of the market.

For example, this month's recommendation, **Carmax**, fits into the early cycle, since auto purchases rise when the economy is healthy and consumer sentiment positive. Consumers are having a near-death experience at the moment, which seems a good a time to bet that their mood will improve. Other sectors that should lead the economy out of economic weakness include financials and technology shares sectors our portfolio has gotten into over the last year.

Though *Sound Advice* builds its recommendations from the bottom up, that is, we begin with no thematic bias and look for companies that are out of favor and selling at historically cheap valuations, we do lift our glance up from specific companies to understand why they have fallen out of favor with investors. Carmax fits the *Sound Advice* criteria, which our current moment in the economy's cycle seconds. If the U.S. economy does recover (hint: it will happen), CarMax should do just fine. ***SA***

Portfolio Updates

Since the last issue was put to bed on April 4th, the market is up anywhere from the Dow's 1.1% to the Nasdaq's 3.1%. Earnings season turned out better than expected, the Fed cut rates again by 25 basis points but implied that it would now pause before considering further cuts, the dollar has stabilized a bit, but energy price went into orbit, credit problems keep on flaring up, the slide in housing prices continues and consumer confidence is shattered. So, for the broad S&P 500 to be up 1.3% is pretty good. Not as good, I admit, as our own portfolio, which jumped 4.6% over the same period thanks to some spectacular leaps from earnings' surprises and from one shocking reversal from what had been our biggest disappointment this year.

The April issue featured four positions punished by the related real estate and credit crises. Three did not much, and one did a lot—all of it to the downside. **HRP** added 3.7% on a total return basis. Much of that addition is the result of subtraction. HRPT announced it was selling 48 properties to Senior Housing Properties, and would pocket $215 million in capital gains. The buildings, all have some medical purpose, are going to what once was part of HRPT before being spun off. **DWS RREEF Real Estate Fund II** shuffled up 0.8%, while **Icon Financial Fund** dropped 1.3% as credit issues again upset the market. The big loser was **American Insurance Group**, which instead of seeing some improvement in the pricing of its derivatives, had to mark down prices further as market conditions deteriorated for the complex swaps and other exotics held in its portfolios. The $15.2 billion write-downs were accompanied by the intention to market $12.5 billion in securities to buttress the balance sheet, which concerns us more than the write-offs, something we continue to think will be reversed to a significant degree as credit markets stabilize and the damaged derivatives return to fairer valuations. AIG did announce a bump up in the annual distribution to $0.88. This did not really make up for the 14.8% drop in the share price. Rather than deciding we are wrong about the reversible nature of much of what AIG wrote off last quarter and again in this, we still are wagering that as the housing crisis subsides and as the derivatives based on mortgages are valued rationally that AIG will more than make up for the pain inflicted. Though we must admit that the decision to sell securities to bolster AIG demonstrates we underestimated the insurer's vulnerability.

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We'll get to the earnings surprises that produced big bounces upward, but first we should talk about **Sprint-Nextel**, which has been a disappointment. It catapulted 43.9% (yes, the decimal point is in the right place) since the last letter. When we recommended S, we believed it had absorbed sufficient punishment for what has turned out to rival in terms of fruitlessness the AOL-Time Warner combination. The Gary Forsee management team that led Sprint to buy Nextel proved unable to make the marriage work. They are gone, and the current CEO, also a Sprint senior executive, finally is getting the company on track, doing good things for customer service, dealing with the mismatched different technologies, and making nice with Wall Street, which Forsee had alienated. More importantly, he has finalized a partnership to develop and deploy the WiMax system, which, if it works, would vault Sprint-Nextel from hopelessly outgunned by Verizon and AT&T to owning a must-have service. Joining Sprint-Nextel are Clearwire, another WiMax developer, **Comcast**, and Time Warner Cable, cable companies that must have a wireless service to compete against Verizon and AT&T, Google that wants a prominent role in turning wireless devices into the Internet's next frontier and Intel, which

Sound Advice Portfolio for May 2008

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
DWS RREEF Real Estate Fund II	SRO	AMEX	$13.40	13.16%	$14.00	BUY
HRPT Properties	HRP	NYSE	$7.36	11.41%	$8.00	BUY
Diversified Growth					.	
Agrium	AGU	NYSE/TSE	$86.70	0.13%	**$98.00**	BUY
American International	AIG	NYSE	$40.28	1.99%	**$48.00**	BUY
Boston Scientific	BSX	NYSE	$13.42	0.00%	$16.00	BUY
Coca-Cola Enterprises	CCE	NYSE	$21.49	1.12%	N/A	**SELL**
Disney	DIS	NYSE	$34.22	0.91%	$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	$44.05	6.27%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	$124.96	14.34%	N/A	BUY
Fastenal	FAST	NASDAQ	$49.81	0.92%	$52.00	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	$14.20	0.28%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	$23.66	0.98%	N/A	BUY
Honeywell	HON	NYSE	$59.59	1.68%	$64.00	BUY
Insituform Technologies	INSU	NASDAQ	$17.80	0.00%	**$21.00**	BUY
Johnson & Johnson	JNJ	NYSE	$66.55	2.49%	$73.00	BUY
CarMax	**KMX**	**NYSE**	**$20.55**	**0.00%**	**$24.00**	**BUY**
Liberty Capital****	LCAPA	NASDAQ	$15.25	0.00%	$20.00	BUY
Mattel	MAT	NYSE	$19.05	3.94%	$25.00	BUY
Microsoft	MSFT	NASDAQ	$29.39	1.50%	$36.00	BUY
Molson Coors Brewing	TAP	NYSE	$56.00	1.46%	$59.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	$10.10	0.00%	$11.00	BUY
Sara Lee	SLE	NYSE	$13.66	3.07%	$17.00	BUY
Schering-Plough	SGP	NYSE	$18.65	1.18%	$22.00	BUY
Sony	SNE	NYSE	$44.74	0.49%	$55.00	BUY
Sprint Nextel	S	NYSE	$9.38	1.07%	**$12.00**	BUY
Superior Industries	SUP	NYSE	$21.78	2.94%	$24.00	BUY
Tetra Tech	TTEK	NASDAQ	$23.25	0.00%	$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	$56.76	3.69%	N/A	BUY
United Parcel	UPS	NYSE	$70.29	2.39%	$76.00	BUY
Wal-Mart Stores	WMT	NYSE	$57.18	1.17%	**$62.00**	BUY
Whole Foods Markets	WFMI	NASDAQ	$32.78	2.20%	$40.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	$52.38	3.90%	N/A	BUY
Xerox	XRX	NYSE	$14.23	1.12%	$19.00	BUY
Energy/Natural Resources						
Anglo-American PLC	AAUK	NASDAQ	$33.38	3.39%	$36.00	BUY
EnCana	ECA	NYSE/TSE	$85.93	1.86%	**$95.00**	BUY
Icon Energy Fund	ICENX	800-764-0442	$34.90	28.03%	N/A	BUY
Plum Creek Timber	PCL	NYSE	$41.60	4.04%	$50.00	BUY
Royal Dutch Petroleum	RDS.A	NYSE	$80.40	3.58%	$87.00	BUY
Transocean	RIG	NYSE	$153.66	24.45%***	**$162.00**	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	$34.85	7.60%	N/A	BUY
Aggressive Growth						
Comcast	CMCSA	NASDAQ	$21.68	1.14%	$24.00	BUY
Discovery Holdings	DISCA	Nasdaq	$26.53	0.00%	**$29.00**	BUY
Electronic Data Systems	EDS	NYSE	$18.86	1.06%	$24.00	BUY
Ford Motor Convertible Pfrd.	F.PRS	NYSE	$36.42	8.92%	$41.00	BUY
Icon Financial Fund	ICFSX	800-764-0442	$10.46	15.96%	N/A	BUY
Liberty Entertainment****	LMDIA	NASDAQ	$26.05	0.00%	$29.00	BUY
Liberty Global	LBTYA	NASDAQ	$34.88	0.00%	$45.00	BUY
Maxim Integrated	MXIM.PK	NASDAQ	$20.74	1.89%	$25.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	$6.25	3.20%	N/A	BUY
Symantec	SYMC	NASDAQ	$19.99	0.00%	**$25.00**	BUY
Time Warner	TWX	NYSE	$15.91	1.38%	$20.00	BUY
Western Digital	WDC	NYSE	$30.39	0.00%	$33.00	BUY

Prices as of the market close on Friday, May 9, 2008

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

****Yield represents a one-time special distribution.***

*****Recently spun off*

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

wants to produce the chips to drive these gadgets. In itself, that news accounts for some of what drove S. In addition, a volley of rumors is pushing shares higher: one rumor has Deutsche Telekom, the parent of T-Mobile, which is the fourth largest cell phone company, wanting to buy Sprint-Nextel and become the largest cell phone network. Some whisper loudly that the old Nextel management team wants to take Nextel private. Another rumor has S spinning off Nextel. There are variations on these basic stories, but the bottom line finally sounds like what we have been saying since the beginning: Sprint-Nextel is a very valuable asset regardless of how management has debased it. If you can tolerate a very volatile ride, this is worth owning now.

The other big recovery story is the **Ford Cumulative Preferred**. It's up 19.1% due to two events: first, the company reported a five-cent a share profit for the quarter, which to put it mildly shocked Wall Street. Shortly after that, Kirk Kerkorian's investment company said it already owned just under 5% of Ford common and would buy another 20 million shares not because he wanted to force changes (as he tried at GM) nor acquire the company (as he tried with Chrysler). He says he just thinks Ford not only will survive but prosper.

Natural Resources and Energy continued their trek higher. **Anglo American**, the diversified mining company, added 5.7%, and was the weakest performer. **Transocean** was up 7.1% on the back of huge backlogs and rising day rates for its ultra-deepwater drilling rigs. Our best performer, **Agrium**, the fertilizer company, completed its acquisition of UAP, a chain of agricultural product stores, and exploded 25.2%, closing at $86.70. At one point, driven by market frenzy, it broke $95.**Royal Dutch** was up 12.2%, **EnCana** 12.1% and **Icon Energy Fund** 11.1%. The only loser, **USAA Precious Metals & Minerals Fund** declined 4.7% as gold dropped into the low $800s before beginning to recover. We think the gold stocks again offer an opportune entry point, since we do not see dollar strength continuing nor geopolitical instability declining. The ace-in-the-hole remains the U.S. governments highly inflationary monetary and credit policies, which cannot be reversed as long as the housing and credit markets remain weak.

Earnings season boosted several of our recovery plays. **Schering-Plough**, which we have been strongly recommending after the roughing up it took from negative reports on its anti-cholesterol drugs Zetia and Vytorin showed better revenues from other products and continued, albeit diminished, interest in it these two contoversial drugs. SGP added 16.1%. **Odyssey Healthcare**, the hospice provider, turned in higher than expected results for the quarter, though still below last year's returns. The keys were lower expenses and the addition of revnue from a recent acquisition, Vistacare. ODSY added 6.2%. Both infrastructure plays, **Insituform** (+15.6%) and **Tetra Tech** (+16.1%) responded to solid earnings. We think there is something more occurring, perhaps an expectation that Washington under the next administration will need to stimulate the economy more constructively than the current Washington financed shopping binge at the mall. Perhaps, and this is purely conjecture, investors are positioning themselves for a boom in infrastructure spending. Certainly the areas these two companies address, water remediation and general environmental cleanups (TTEK), and sewage and water pipe replacement (INSU) are dire problems demanding solution.

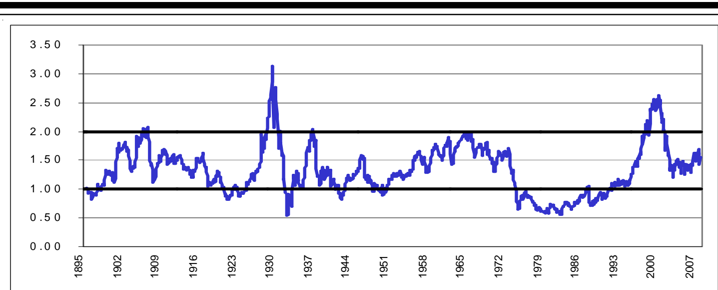
Of course there were disappointments from earnings season. **Mattel**, which had been recovering from bad press and revenue hits from repeated recalls of toys produced in China, came up short, blaming recall costs and slower sales domestically for Barbie-related items. MAT over the last month fell 12%. **Coca Cola Enterprises**, the soft-drink bottler, fell short and blamed the slow economy. The shares are off 11.7%. Though senior executives responded to the drop by buying sizeable positions, <u>we are selling CCE</u>. It's been an OK investment, but nothing more. We are skeptical about the slow economy story, because our other beverage stock, **Molson Coors**, reported better than expected results for sales volume and earnings. Since the last letter, TAP is up 2.8%, so-far this year.

With the exception of **Liberty Capital**, which lost 8.6%, all our media stocks were strong. **Comcast** added 6.9%, **Time Warner** 9%, **Disney** 9.5%, **Sony** 6.8% **Discovery Holdings** 22.2%, **Liberty Entertainment**, which is a tracking stock carved out of Liberty Capital, added 4.8%. The driver for each differed somewhat, but the common theme is that in addition to better than expected quarterly results, each has now shown itself to be less vulnerable to any economic slowdown. ***SA***

Sound Advice Market Indicators for May 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 75 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 1.47.

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 31.1 percent, not counting dividends. On an annualized bases the gain was 16.2 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

Buy Signals Date	S&P 500	Sell Signals 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 0.82 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 (See page one for the stats.). ***SA***

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