

## The Trillion Dollar Infrastructure Plan



The *Sound Advice* Portfolio is up 4.5 percent so far this year, as compared to 5.5 percent for the S&P 500. We have an average profit of 67 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

*“Crumbling infrastructure will be replaced with new roads, bridges, tunnels, airports and railways gleaming across our beautiful land... To launch our national rebuilding, I will be asking the Congress to approve legislation that produces a \$1 trillion investment in the infrastructure of the United States — financed through both public and private capital — creating millions of new jobs.”*

Trump's recent address to the joint session of Congress sent the Dow Jones soaring 350 points the following day; led by construction and infrastructure stocks. The Trump Administration has since started working on its infrastructure plan. Gary Cohn, the ex-CEO of Goldman Sachs and now the Director of the National Economic Council, is organizing officials from 15 federal agencies and departments to identify the most urgent infrastructure projects. More than 400 shovel-ready projects have been submitted by the National Governors' Association.

Trump's \$1 trillion infrastructure spending program would be the biggest reinvestment into America since Eisenhower's interstate highway program in the 1950s. The American Society of Civil Engineers estimates that \$3.3 trillion is needed to fund US infrastructure projects through 2025, ranging from energy infrastructure to bridges and roads.

### Regulatory Burden

Rolling back and streamlining regulations is part of the plan. Trump's campaign website says:

*“Infrastructure projects across the US are routinely delayed for years and years due to endless studies, layer-upon-layer of red-tape, bureaucracy, and lawsuits—with*

*virtually no end in sight. This increases costs on taxpayers and blocks Americans from obtaining the kind of infrastructure that is needed for them to compete economically.”*

The website also says that Trump wants to link spending to reforms that *“streamline permitting and approvals, improve the project delivery system, and cut wasteful spending on boondoggles.”*

### Funding Ideas

There is bipartisan agreement that a tremendous number of urgent projects exists, but how to pay for them has yet to be proposed. One bipartisan bill, sponsored by Rep. John Delaney (D-MD), links the infrastructure program to tax reform. Another funding source being considered is revenue from a reduced tax to incentivize international corporations to repatriate mountains of capital now stored overseas.

Other potential sources are public-private partnerships (PPPs), tax credits, and other tax incentives to attract private capital. Trump's proposal specifies \$137 billion in federal tax credits to prompt \$1 trillion of investment in infrastructure projects during the next 10 years. The expense of these incentives would be offset from increased tax revenue from new construction wages and contractor profits.

Another source of funding could come from receipts from a “repatriation” tax. Currently, companies can defer paying income taxes on their offshore profit until they return those earnings to the US. This has resulted in a stockpile of \$2.6 trillion in income offshore that would be taxed at the highest corporate tax rate of 35 percent. Trump is proposing to lower that rate to 10 percent to incentivize companies to return that money to America. Even a 10 percent tax would produce a multibillion-dollar revenue infusion that could be used toward infrastructure expenditures.

In March, Trump's administration began exploring the idea of a national “Infrastructure Bank”, which has been a favorite of Democrats. “Build America Bonds” are also on the list, supported by tolls or set payments, which could have maturities of 50 to 100 years.

### Timing

The target for commencing the infrastructure program was scheduled for 2018. However, in the final days of March, the Trump administration began considering putting tax reform and infrastructure together in a single package for 2017. The marriage of the infrastructure program with tax reform is expected to bring in support from Democrats and reduce the need for support from the ultra-conservative House Freedom Caucus (which did not support the Obamacare vote).

Former Goldman Sachs president Gary Cohn, and now the leader of Trump's National Economic Council, is leading the effort to craft the White House tax overhaul plan which is to be released in a matter of within weeks.

## Energy Infrastructure

In addition to a \$1 trillion infrastructure program, the Trump administration has the goal of making America energy independent by eliminating America's dependence on imported oil. To make measurable headway toward this goal, two major accomplishments would have to take place.

First, domestic energy production would have to increase substantially. To be completely independent from importing oil, US production would have to double. Trump notes that this is achievable because "America has 1.5 times as much oil as the combined proven resources of all OPEC countries; we have more Natural Gas than Russia, Iran, Qatar and Saudi Arabia combined; we have three times more coal than Russia."

The second accomplishment would be to drastically improve the US energy infrastructure system to get US oil and gas transported to where it can be utilized. Refiners on the east and west coasts do not have access to US pipelines. As a result, coastal refiners must depend on supplies of imported oil delivered into seaports in order to furnish these heavily populated areas with sufficient supplies of gasoline. Accordingly, a vast new energy infrastructure must be developed inside the US, including pipelines, refineries, and storage facilities.

The US also has plentiful supplies of clean-burning natural gas, but an infrastructure of pipelines is needed for it to be more widely used. More liquefied natural gas (LNG) plants also need to be developed to freeze natural gas into a liquid form for transportation.

In order to expedite these goals, the Trump administration is promising to roll back environmental regulations. At the end of March, President Trump signed an executive order rescinding several of Obama's executive orders and policies aimed at reducing carbon emissions from power plants. After signing his executive order, Trump said:

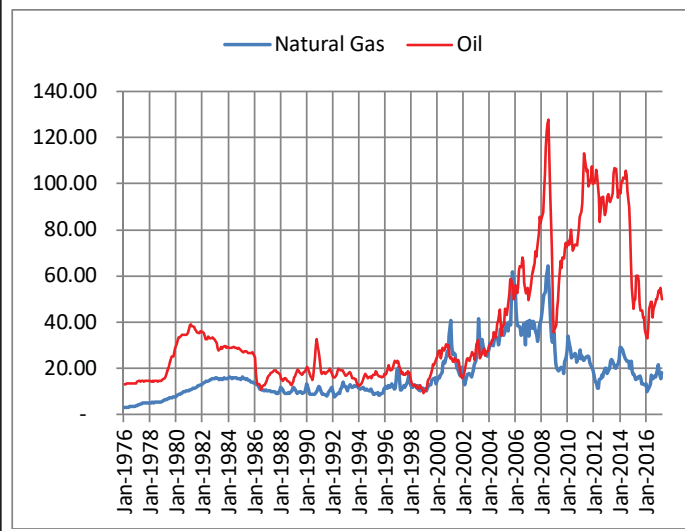
*"My action today is the latest in a series of steps to create American jobs and to grow American wealth. We're ending the theft of American prosperity and rebuilding our beloved country."*

## Chicago Bridge & Iron

In our mid-March email, we introduced **Chicago Bridge & Iron (CBI)** to the *Sound Advice* portfolio. Nearly all (90.4 percent) of CBI's operating income is generated from clients in infrastructure-related industries, and energy-related infrastructure projects are CBI's specialty. Accordingly, CBI is well positioned to benefit from increased US infrastructure spending and expansion, especially for the energy sector.

CBI has three operating segments offering specialized services that are often integrated for large complicated projects. In 2016, close to half (47 percent) of the company's operating income came from its Engineering & Construction segment, primarily for energy-related projects. Twenty-eight percent came from the company's Fabrication segment, which makes steel-plate structures used in liquefied natural gas terminals, electric power-plant projects, and pipeline systems for both water and energy substances. Sixteen percent came from the Technology segment

## The Cost of Energy Equivalents of Oil and Natural Gas



which provides proprietary engineering services primarily for the petrochemical and refining industries.

Key US projects in 2016 included the completion of ethane crackers (refiners) in Texas and Louisiana, an LNG plant in Texas, and power plants throughout the US. Conversion of US power plants from burning coal to natural gas is also in CBI's wheelhouse. CBI generated 70% of its revenue from US projects in 2016. That percentage is bound to rise with increases in American infrastructure expenditures.

Two years ago, quarterly revenue peaked at \$3.38 billion and then went into a decline along with the slide in energy prices. CBI stock fell from \$58 to a low of \$26 in September 2016. Then, Trump's election sent infrastructure stocks soaring; including CBI which climbed from \$28.56 before election-day to \$36 as late as February 15, 2017. Since then, because of a disappointing fourth quarter earnings report, CBI has retraced that gain. This retracement is providing a timely buying opportunity.

CBI reported a loss of \$313,169 for 2016. However, this loss included \$803,148 in a one-time, paper impairment charge taken in the fourth quarter. Otherwise, the company earned \$4.23 per share.

During 2016, CBI used some of its cash flow to reduce its debt from \$2.4 to \$2.2 billion. The company is selling its Capital Services segment for \$755 million, the proceeds of which will be used to reduce debt below \$1.5 billion. This debt compares to current assets of cash and equivalents of \$2.54 billion, and total assets of \$7.84 billion. Accordingly, CBI is not dangerously leveraged with debt.

Gross revenues were \$10.68 billion in 2016. CBI ended the year with a backlog of contracts totaling \$18.46 billion. Although down slightly from \$19.77 billion at the end of the third quarter, CBI has a robust pipeline of projects.

In its fourth quarter earnings conference call, the Chief Financial Officer, Michael Taff, gave the company's earnings guidance for 2017. He said that CBI expects to generate earnings between \$4.00 and \$4.60 a share. At the low end of this range of \$4.00, the

stock is selling at less than 8 times earnings.

Currently, the overall market, as measured by the S&P 500 index, is trading at a price/earnings (P/E) ratio of close to 18, based on estimated earnings for 2017. CBI's P/E at less than 8 puts it at a steep discount to the overall market.

Of course, Trump's infrastructure and energy programs are long-term in nature, with substantial uncertainties and lead-times. However, they offer a significant growth path for CBI and justify a much higher P/E, and thus a much higher stock price. For example, a P/E of 15 based on earnings of \$4.00 would push CBI to \$60 per share – essentially doubling its current price.

## Portfolio Updates

The portfolio is currently designed with a cautious approach, as suggested by the "Caution" signal in force by the *Sound Advice* Diffusion Index of Lagging Indicators (page 11) which is telling us that interest rates will continue rising.

An additional reason for caution is the fact that the market has made a stunning rise since Trump's election, anticipating the positive impacts of tax reform and new infrastructure spending. As we discussed in last month's issue, the GOP tax reform plan would introduce a "border adjustment" tax by disallowing corporate expenses for imports. GOP House leaders expect the White House tax overhaul plan to incorporate a border adjustment tax. This concept introduces a sweeping change and would have an adverse impact on a number of industries. The market is likely to be buffeted in the weeks ahead by political debates which will raise uncertainties regarding tax reform and infrastructure funding sources.

## Energy & Natural Resource Selections

President Trump's "America First Energy Plan" is aimed at giving energy independence to the US by unleashing America's \$50 trillion in untapped shale, oil, and natural gas reserves. This goal is being made easier by the fact that cost-cutting and better technology in the US oil patch is bringing down costs. In the most prolific areas, which include the Permian Basin and Eagle Ford, drilling costs have declined below \$36 per barrel. As a result, shale producers have continued to drill and pump, as evidenced by the continued rise in record-high US oil supplies.

One victim of the continued advances in US shale drilling is **Transocean (RIG)** which makes deep-water drilling rigs. Offshore drilling, even in relatively shallow water, is not viable with oil below \$70. In March, Transocean agreed to sell its fleet of 15 "jack-ups", rigs that operate in 400 feet of water or less. In order to compete with shale producers, large oil companies are taking fewer rigs to their deep-water locations. Instead, they are pulling substantial amounts of oil out of areas that were once thought to be played out by drilling horizontally and bringing the new oil back to the original location with horizontal pipes. This technique is bringing the cost of deep-water oil below \$40 per barrel. These new techniques and efficiencies are extending RIG's road to recovery. Accordingly, we are selling RIG to deploy capital to more promising areas.

As we explained last month, the GOP tax overhaul plan has a "border adjustment" feature to compensate for a corporate tax cut to a flat 20 percent rate. This feature would make the cost of imports taxable by disallowing them to be business expenses. Exports, on the other hand, would not be taxed. The effect on the

energy industry would be to tax imported oil coming into the US while encouraging exports. This would be especially beneficial to energy producers inside the US, and neutral to those producing outside the US, as long as the energy is sold elsewhere.

The additional cost of imported oil would be problematic for refiners because US oil refiners are generally designed to refine heavier grades of crude oil imported from Canada and Saudi Arabia, rather than light crude oil that is typically produced inside the US. Refiners on the east and west coasts have less flexibility because they do not have access to US pipelines and need to rely more heavily on supplies of imported oil.

**Chesapeake Energy (CHK)** has a portfolio of close to 8 million net acres of oil and gas assets inside the US in areas called the Haynesville/Bossier, Marcellus, Eagle Ford, Powder River Basin, Utica, and Anadarko Basin regions. As purely a domestic producer, CHK is well situated to benefit from the GOP tax plan or any plan involving border adjustments or tariffs on imported oil.

As part of the on-going cost cutting efforts, the company has chopped the number of employees from 13,000 to 3,300. The consensus among analysts is that CHK will earn 65 cents per share in 2017. A P/E ratio of 10 puts the stock at \$6.5. A P/E closer to the overall market of 15 puts the stock close to \$10.

CHK is focusing on developing its oil producing properties because oil brings three times more cash than gas on an energy equivalency basis. (We have been noting this inconsistency in these pages. See the nearby chart.) CHK is planning 320 new crude wells versus 90 for natural gas. The company expects oil output to grow by 10 percent this year with the goal of doubling in 2018. Company insiders have purchased a net of close to 2.7 million shares during the last 12 months.

**Chevron (CVX)** is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these stages of production, depending on the prices demanded for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. Conversely, when oil prices are low, profit margins expand from refining. Management has pronounced the annual dividend as "sacrosanct" which provides an attractive yield and limits the downside risk.

Chevron has a huge proved reserve base of 11.2 billion barrels of oil equivalent. Production is set to increase in 2017. Two leading projects began production during the second half of 2016: the Bangka project in Indonesia and the Alder project in the North Sea. One of the large Australian LNG projects, Gorgon, started production in 2016, and the other large Australian LNG project, Wheatstone, is scheduled to commence in mid-2017. There is plenty of foreign demand and existing contracts for these foreign sources of production, and oil or gas sold outside the US would not be impacted by the GOP border adjustment tax plan. Inside the US, the company's 2 million acres in the prolific Permian Basin will be an important area of focus in 2017.

**Fidelity Select Natural Gas Fund (FSNGX)** is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At the current price of

\$50 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at \$3.15 for one million BTUs, 5.8 million BTUs will cost \$18.27. Thus, the same amount of energy is available for approximately 37 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart shows the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

**ICON Energy Fund Class S (ICENX)** is also a diversified way to participate in the recovery with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sector to capture value, rather than simply depending on rising oil prices. This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management.

**Freeport-McMoRan (FCX)** is the world's largest copper producer. Copper prices typically rise during economic expansions because of the wide use of copper for new construction. Low copper prices in recent years have forced miners to cut back on exploration and development which has been reducing supplies. Projections from industry analysts call for shortages to begin appearing from as early as this year to the next few years. Trump's infrastructure spending will be a large boost, and the amount and timing of the actual spending will play a significant role.

FCX acquired substantial oil and gas assets at the top of the market in 2013 and took on close to \$20 billion of debt to do so. To survive the downturn, the company has been selling assets to reduce its debt burden. FCX sold \$6.6 billion in non-core assets in 2016, and reduced debt by \$8 billion down to \$11.8 billion. The company states that there are no additional asset sales required.

FCX is still at loggerheads with the Indonesian government who is trying to collect more revenue and gain control of Freeport's huge Grasberg copper mine. FCX has cut production from the site by 40 percent during negotiations (which has contributed to a world-wide rise on copper prices). The production cut has come to a critical juncture for both parties. FCX derives one-third of its copper output from Grasberg, and Indonesia stands to lose hundreds of millions of dollars in annual payments, and its demands could undercut Indonesian President Joko Widodo's campaign to attract foreign infrastructure investments. The battle has been suppressing the stock. Resolution would be in the interests of all parties.

**Valero Energy (VLO)** is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland. Profitability in refining is a function of the so-called "crack spread", the difference in the amount a refiner pays for crude oil and the amount for which it sells the resulting refined products such as gasoline and jet fuel. Fluctuations in these prices compress and expand margins which can make refining stocks volatile at times. Valero is the most complex refiner in the US, which allows it to purchase lower quality crudes when they are priced at the most advantageous discounts. This flexibility

allows VLO to capture the highest margins among its competitors.

Unlike most of its peers, Valero's refineries have access to US crude supplies and the flexibility to refine 600,000 to 1 million barrels per day of light domestic crude. Valero's refining flexibility, gulf coast locations, and access to US pipelines give it an advantage over its peers. Valero is exporting more than 300,000 barrels of gasoline and 75,000 barrels of diesel a day to Mexico which is importing 60 percent of its gasoline and 50 percent of its diesel requirements. Profits from exports would not be taxable under the GOP border adjustment tax plan.

## ETFs for Rising Interest Rates

The combination of corporate tax cuts, infrastructure spending, deregulation, and repatriation of capital trapped overseas is bound to stimulate significant economic growth. The era of historically low-interest rates is clearly over.

Our recommended ETFs, designed to benefit from the normalization of interest rates and long-term bond yields, differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

The **Direxion Daily 20 Plus Year Bear 3 Shares (TMV)** uses 3:1 leverage.

The **Proshares UltraShort Lehman 20 Plus Year Treasury (TBT)** uses 2:1 leverage.

The **Proshares Short 20 Plus Year Treasury (TBF)** uses no leverage.

The price action of these ETFs is based on the changes in long-term treasury bonds, as measured by benchmark bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. We have been using the Federal Reserve's prediction, which was as good as any. As part of the Federal Reserve's quarterly Federal Open Market Committee (FOMC) meetings, each of the 17 committee members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot".

The most recent Dot Plot was taken at the March 15 meeting. As usual, there was a wide difference in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end 2017, 2.125 percent at the end of 2018, and 3.00 percent at the end of 2019.

It is worth noting that the March Dot Plot projections were essentially unchanged from the December Dot Plots. FOMC Members base their opinions on the most recent data available, and use older data for context. Accordingly, monetary policy is generally a reaction to recent and past conditions. That is why the Federal Reserve is usually "behind the curve" when major economic shifts take place, and this time appears to be no exception. Accordingly, it is probable that the March Dot Plots will likely end up to be low. However, in the spirit of being conservative, we can use these Dot Plots as a basis of a forecast. Assuming long-term Treasury bond yields move in accordance

## Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate (\$Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	23.51	5.6%	12.2%	6,558.5	43.84	-46.4%
Hospitality Properties	HPT	32.00	6.4%	10.1%	11,262.3	50.61	-36.8%
Hersha	HT	18.79	6.0%	9.5%	2,237.9	23.23	-19.1%
Host Hotels & Resorts	HST	18.66	4.3%	9.4%	20.7	24.19	-22.9%
Apple Hospitality	APLE	31.53	3.8%	5.3%	5,212.2	20.26	55.6%

The table above shows the "Stock Market Cap Rate" (what the stock price is paying for the underlying real estate portfolio) for several comparable hospitality stocks. The "Stock Value" column shows the current value of the stock assuming the underlying portfolios are valued using a cap rate of 7.5 percent, which is close to the average cap rate on recent hotel transactions. The last column shows the discount or premium at which the stock is trading based on a 7.5 percent cap rate valuation of each company's real estate portfolio.

with these target points (to preserve the same as today's real return), long-term Treasury bonds would be yielding 3.64% by the end of 2017, and 4.39% by the end of 2018, and 5.26% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from \$22.38 to \$31.00 by the end of 2017, to \$44.49 by the end of 2018, and to \$65.51 by the end of 2019.

TBT would rise from \$39.23 to \$52.34 by the end of 2017, to \$62.03 by the end of 2018, and to \$80.29 by the end of 2019.

TBF would rise from \$23.46 to \$26.15 by the end of 2017, and to \$29.50 by the end of 2018, and to \$33.57 by the end of 2019.

### The Erosion Factor

As pointed out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.04 percent (4 basis points) every day, and thus go nowhere through the end of 2017. Here is what would happen to each ETF:

TMV would decline to \$20.72 by the end of 2017 (7.4%).

TBT would decline to \$37.63 by the end of 2017 (4.1%).

TBF would decline to \$23.09 by the end of 2017 (1.6%).

While not insignificant, this erosion factor is nominal in

comparison to the price swings caused by a change in bond yields.

### Real Estate Selections

We recently sold **Retail Opportunities Investment Corp (ROIC)** because the stock price was paying a lofty 5 percent capitalization (cap) rate for the underlying portfolio. (The cap rate is the cash yield before debt payments are considered.) As in the case of ROIC, the average real estate investment trust (REIT) does not present a particularly good value. Low interest rates have pushed down real estate cap rates to historically low levels (like bond yields). As a result, commercial real estate prices are historically high. Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now. Two currently exist in the hospitality industry.

The table above shows the comparative values of other hospitality REITs. **Hospitality Properties (HPT)** has the second largest discount. However, this company is externally managed by RMR which charges high fees and suppresses value. As long as RMR continues to externally manage HPT, we do not expect to see significant growth. **Host Hotels and Properties (HST)** is very small, with only 749 thousand shares outstanding, which may lead to excessive volatility. Growth may be limited by its small capitalization. **Apple Hospitality (APLE)** is trading at a slight premium.

**Hersha Hospitality (HT)** is a real estate investment trust which owns and operates high quality upscale hotels in urban

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gateway markets. The Company's 55 hotels totaling 8,654 rooms are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast. Many of HT's major properties have been undergoing renovations and not producing their full income potential. As renovations are completed and rooms are put back on line, revenue and FFO should climb substantially higher. New acquisitions will also contribute to growth, along with sales of less-attractive properties.

So far this year, moves to upgrade the portfolio include the sale of the Courtyard by Marriott in Alexandria, VA, and the Residence Inn in Greenbelt, MD. The sales were based on a 7.4 percent cap rate. The sale of the company's suburban West Coast portfolio is anticipated to close in July, which is expected to fund a tax-deferred exchange to acquire the 153-room Pan Pacific Hotel in Seattle. The Ritz-Carlton in Coconut Grove, FL, was purchased this year.

During the last several years, Hersha has reported several hotel transactions it made at cap rates ranging from 5.4 to 8 percent. To be on the conservative side, we can establish a main street cap rate at the high end of this range, of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters' financials, including the most recent 2016 fourth quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value HT at \$23.23 per share which is significantly higher than the current price. The dividend yield is attractive and lowers the risk profile. Hersha is repurchasing up to \$100 million of its shares in 2017.

**RLJ Lodging Trust (RLJ)** is also currently selling at a steep discount to its hotel assets. RLJ has a large, geographically diversified portfolio of 125 hotels, branded by Marriott, Hilton, Hyatt, and Embassy Suites with over 20,000 rooms. Rather than traditional full service hotels, RLJ emphasizes "focused-service" or "compact full service" hotels, where only specially chosen services important for guests are offered. The most important amenity is an attractive, modern room offering quality features for the basic necessities – sleeping, bathing, and working. Minimized are amenities such as large restaurants, spas, and meeting rooms. Overall, the hotels are mid- to up-scale, but with reasonably-priced rooms. This concept translates into a larger portion of revenue from the rooms.

The company is on a mission to upgrade its assets by purchasing properties in high growth markets with barriers to entry. The company is also seizing opportunities to sell at high prices, such as the recent sale of two of its New York City hotels at a lofty 4.7 percent cap rate.

Based on the latest trailing four quarters' financials reported, including the most recent 2016 fourth quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at \$43.84 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

**Third Avenue Real Estate Value Investor Fund (TVRVX)** is loaded with good values substantially below NAV with strong growth prospects. Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic value. Just as we do at *Sound Advice*, they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

TVRVX has a number of distinguishing characteristics. This is a global real estate fund. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management also searches for opportunities in different aspects of a real estate company's capital structure by investing in senior debt in addition to equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities.

### Medically-Related Selections

The failure to repeal and replace the Affordable Care Act (Obamacare) does not eliminate the cloud of uncertainty blanketing the health care industry; it simply extends it until the topic is taken up again in the future. How this will all shake out is anyone's guess, which means it is too early and uncertain to look for new investments in this area.

Aside from Obamacare, Trump is after pharmaceutical companies to lower prices. He also appears favorable to repeal the law that forbids Medicare from negotiating drug prices. For these reasons, our portfolio is conspicuously void of pharma stocks. We are comfortable with our current recommendations in this sector based on their own individual merits.

**Boston Scientific (BSX)** produces medical products well suited for an aging population. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs.

In March, a study was published showing that a new method of inserting a heart valve through a catheter while pushing the old valve aside, could be a better alternative than open-heart surgery. BSX is testing products in this area.

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

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cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions.

In March, SYK launched its MAKO System of a robotic-arm assisted total knee arthroplasty surgical system, the first and only robotic technology for knee, hip and partial knee replacements.

**Tekla Life Sciences Investors (HQL)** is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 15 years, biotechnology has become a major industry and the source of the world's top breakthrough drugs. Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

In exchange for lowering drug prices, Trump is promising to streamline the approval process for new drugs and treatments, which would be a substantial benefit to this sector.

### Small Caps

Small caps tend to be domestic companies without substantial overseas exposure. They are typically not buffeted by the currency fluctuations that often haunt larger companies.

Numerous studies show that small caps perform better over the long run than the market as a whole. They are pure plays on the early stages of new industries and inventions, they have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually quite profitable.

**Third Avenue Small-Cap Value Investor Fund (TVSVX)** invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), and the ability to consistently grow NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

### Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

**Arconic (ARNC)** is the spin-off from the downstream operations of value-added products from Alcoa (AA). We recommended selling AA and investing the proceeds in ARNC. Since then, ARNC has had a stellar rise.

Arconic manufactures specialty metal products for aerospace and defense, building and construction, and automotive industries. Arconic is one of only a few companies with the expertise and assets to use uniquely advanced metallurgical techniques to produce metals that can withstand harsh environments, such as within a jet engine, as well as in other vital uses in products that must not fail.

Elliott Management, an activist investment firm, recently raised its investment in ARNC to 13 from 11 percent of ARNC's shares, and believes ARNC is "dramatically undervalued." Elliot Management wants to oust Alcoa's current chief executive officer Klaus Kleinfeld and replace him with Larry Lawson, the former

CEO of aircraft parts maker Spirit AeroSystems Holdings. Elliot Management wants a "proven operator" as CEO.

In March, ARNC announced a multi-year supply deal with Toyota to supply the aluminum for the exterior aluminum panels on the Lexus RX. Auto makers claim that aluminum vehicles have better fuel efficiency and improved vehicle safety scores.

**Apple (AAPL)** has a pristine balance sheet, with as much cash as long-term debt, with the highest A++ financial ratings. The stock market has been giving APPL a below-average price/earnings (P/E) ratio because of slow and even negative growth prospects. However, the demise of Samsung's latest Galaxy Note 7 phone has flung open the doors for a significant new growth path. Samsung has been Apple's fiercest competitor, with 22.4 percent of the market share of smart phones – nearly double that of Apple's 11.8 percent share. Slightly more than one-half of Apple's revenue comes from its iPhones, so a gain of just one percent in market share translates to 14 million iPhones, which would add 7 percent to revenue. In addition, the new *iPhone 7* and *7 Plus* have been well received which is inaugurating a long-awaited upgrade cycle. The iPhone 8 is scheduled for the next upgrade cycle which is rumored to offer a larger screen through a reduced bezel, and recognize the face of its authorized user.

**Conduent (CNDT)** is the consulting and outsourcing company that was spun off from Xerox. CNDT is basically the company that XRX purchased in 2010 called Affiliated Computer for which Xerox paid \$6.3 billion and assumed \$2 billion of debt. At the time of acquisition, Affiliated Computer had \$6.5 billion in sales and an operating margin of 10.5 percent. After 6 years of mismanagement, the operating margin dropped in half with no growth in sales. Still, this was the growth side of the old Xerox, with expertise in transaction-intensive processing, analytics, and automation. This side of the business had an 86 percent contract renewal rate.

Now, as a stand-alone company, with fresh new management and specific growth goals, CNDT is basically a turnaround company with upside. Carl Icahn holds 9.77 percent of the stock which means he had influence and a reason to see growth.

**International Business Machines (IBM)** was introduced in our January 24, 2017, email update called *Introducing Watson*. IBM is turning into a growth stock, thanks to the growth of its artificial intelligence division based on Watson, the Company's super computer that can "think" like a human. Watson cognitively scans a world of data and applies relevant information to what it learns about a company's business and systems to create new revenue streams, reduce expenses, and make existing operations more efficient. We have only begun to see and imagine the uses of artificial intelligence. IBM is the leader in that field and on a solid path to provide a growing abundance of opportunities in the months and years ahead.

In March, IBM signed an agreement with the Wanda Internet Technology Group, one of the largest commercial and enterprise groups in Asia, to give Chinese businesses access to IBM's cloud infrastructure platform. IBM will first introduce Watson Conversation services which will allow developers to add natural language interactions between apps and customers. Additional Watson services are planned to be rolled out in the future.

IBM is a good value now. The company expects 2017 earnings to be "at least" \$11.95. We can simply look at IBM's current P/E of 14 to see the profit potential. For example, if the P/E of IBM

increases to 17, which is still below the average of the overall market, the price of IBM would climb above \$200 per share.

**NCR Corp (NCR)** makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

NCR is experiencing strong growth in both its Software and Hardware segments. The software side is expanding its cloud and software license offerings while the hardware side is seeing strong demand for its Self-Checkout and ATM edge platforms.

We added NCR to the portfolio when it was close to 10 times earnings. NCR has climbed substantially, but it is still selling below the market average price earnings ratio.

**Symantec (SYMC)** is the world's leading cyber security company offering the world's organizations strategic, integrated solutions to defend against sophisticated attacks across endpoints, cloud and infrastructure. Symantec operates one of the world's largest civilian cyber intelligence networks, allowing it to see and protect against the most advanced threats. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

SYMC has seen a turnaround, fueled by the disposition of under-performing past acquisitions and making new ones, particularly LifeLock and Blue Coat. Management's focus in 2017 is to perpetuate and integrate the synergies of these new acquisitions into Symantec's operations. LifeLock's identity theft solutions add new growth dimension to SYMC because consumers pay two to three times more for identity protection than for endpoint malware protection.

Also adding to growth are increased regulations across Europe, requiring companies to update and adopt state-of-the-art cyber security measures.

**Tetra Tech (TTEK)** is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. Two recent acquisitions of Coffey and INDUS corporations have swelled TTEK's backlog of contracts and increased prospects for more Federal contracts in the IT sector. The company's backlog is now \$2.3 billion, which reveals a robust pipeline with major government organizations like the US Department of State, US Army Corps of Engineers, and the US Air Force, which should continue to bolster growth. The Trump Administration's infrastructure plans are bound to unlock additional opportunities for Tetra Tech.

**Wells Fargo (WFC)** will be a beneficiary of rising interest rates, and deregulation could expand business opportunities. WFC has lagged in the bank rally due to last year's scandal regarding unauthorized account-opening practices. While there may still be some fall-out, management has changed and

the issue is basically history. In March, Tim Sloan, WFC's new President and CEO, assured Warren Buffet that the bank is on the right track. Buffet's Berkshire Hathaway is the largest holder of WFC with 10 percent of the outstanding shares. Buffet said that Tim Sloan was the right man for the job.

Trump's campaign promises and subsequent executive order to loosen bank regulations to promote lending is a positive force for the banking industry. For example, Goldman Sachs estimates banks could see earnings increases ranging from the mid-teens to 28 percent even though the bulk of the regulation framework will not change.

The relatively low price of WFC makes it a strong value and a timely investment. Even without the deregulatory benefits, WFC's 2017 earnings are expected to be \$4.45 per share. Even with

no expansion in the current price/earnings (P/E) ratio, the stock would be \$62 based on 2017 earnings. However, we expect more upside because the P/E ratio should expand due to brighter growth prospects. At a P/E ratio of, say 18 which is still below the overall market average, WFC would be \$80 per share – considerably higher than it is now.

**Xerox (XRX)** spun off its business services unit in early January to **Conduent (CNDT)**. XRX should benefit from new separate leadership

and goals, and better focus and execution under its new CEO, John Jacobson, who is bringing a new enthusiastic corporate culture and a three-year strategy for growth.

Xerox is rolling out 29 new products aimed at mid-size companies which are stronger growth targets than large-scale businesses. An area of focus is "smart-label" technology directed at food and drug companies. Smart labels are printed electronic circuits that allow items to be identified and tracked in real time. They can be produced for a fraction of the cost of silicon sensors and used on small packages. This is a wide-open and high-growth market.

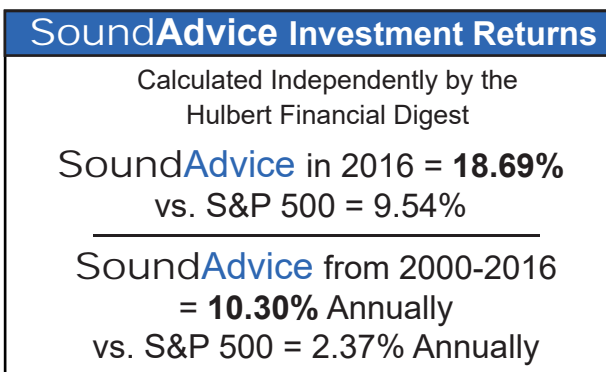
On the expense side, the company has begun a cost-cutting program that aims to save as much as \$1.5 billion over the next three years.

XRX is still cheap relative to the rest of the market, especially with new growth paths to be implemented under the watchful eyes of Carl Icahn who holds 9.77 percent of the stock. The dividend yield is also attractive.

## Hedging the Portfolio

Our **SoundAdvice Diffusion Index of LAGGING Indicators** (page 11) is warning us to be cautious. Accordingly, we are also recommending a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500.

The **ProShares UltraShort S&P 500 (SDS)** is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.



Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	\$5.94	0.00%	BUY	\$6.50
Chevron	CVX	\$107.37	4.02%	BUY	\$120.00
Fidelity Select Nat. Gas Fund	FSNGX	\$27.52	0.45%	BUY	\$32.00
Freeport-McMoRan	FCX	\$13.36	0.00%	BUY	\$15.50
ICON Energy Fund Class S	ICENX	\$12.94	0.42%	BUY	\$14.50
<b>Transocean</b>	<b>RIG</b>	<b>\$12.45</b>	<b>0.00%</b>	<b>SELL</b>	
Valero	VLO	\$66.29	3.62%	BUY	\$69.00
Real Estate					
Hersha Hospitality Trust	HT	\$18.79	5.96%	BUY	\$21.50
RLJ Lodging Trust	RLJ	\$23.51	5.61%	BUY	\$26.00
Third Avenue Real Estate Value Investor	TVRVX	\$32.13	0.51%	BUY	\$35.00
Medically Related					
Boston Scientific	BSX	\$24.87	0.00%	BUY	\$27.00
Stryker Corp.	SYK	\$131.65	1.29%	BUY	\$135.00
Tekla Life Sciences Fund	HQL	\$19.39	0.00%	BUY	\$21.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	\$21.65	0.30%	BUY	\$24.00
Special Situations					
Apple	AAPL	\$143.66	1.59%	BUY	\$145.00
Arconic	ARNC	\$26.34	1.37%	BUY	\$31.00
<b>Chicago Bridge &amp; Iron</b>	<b>CBI</b>	<b>\$30.75</b>	<b>0.91%</b>	<b>BUY</b>	<b>\$33.00</b>
Conduent	CNDT	\$16.78	0.00%	BUY	\$18.00
In't Business Machines	IBM	\$174.14	3.22%	BUY	\$185.00
NCR Corp	NCR	\$45.68	0.00%	BUY	\$50.00
Symantec	SYMC	\$30.68	1.04%	BUY	\$32.00
Tetra Tech	TTEK	\$40.85	0.88%	BUY	\$43.00
Wells Fargo	WFC	\$55.66	2.73%	BUY	\$62.00
Xerox	XRX	\$7.34	3.81%	BUY	\$8.50
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	\$22.38	0.00%	BUY	\$27.00
ETF - ProShares Short 20+ Year Trsry	TBF	\$23.46	0.00%	BUY	\$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	\$39.13	0.00%	BUY	\$44.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	\$13.45	0.00%	BUY	\$15.00

**Notes to the table:** The right hand column is the highest recommended price limit for purchases. Prices are as of 3/31/2017. See our website for live pricing and buy limits:

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

**General Comments:** Our statistics are based on the assumption that \$10,000 is invested in each position. When a new position is added, we assume the same \$10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, as we have done over the years, we assume another \$10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

As always, broad diversification will temper volatility, add to safety, and improve long-term performance.

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

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

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

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

We can, therefore, label this new tool the SoundAdvice "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and

are on the verge of declining or under performing the other market.

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

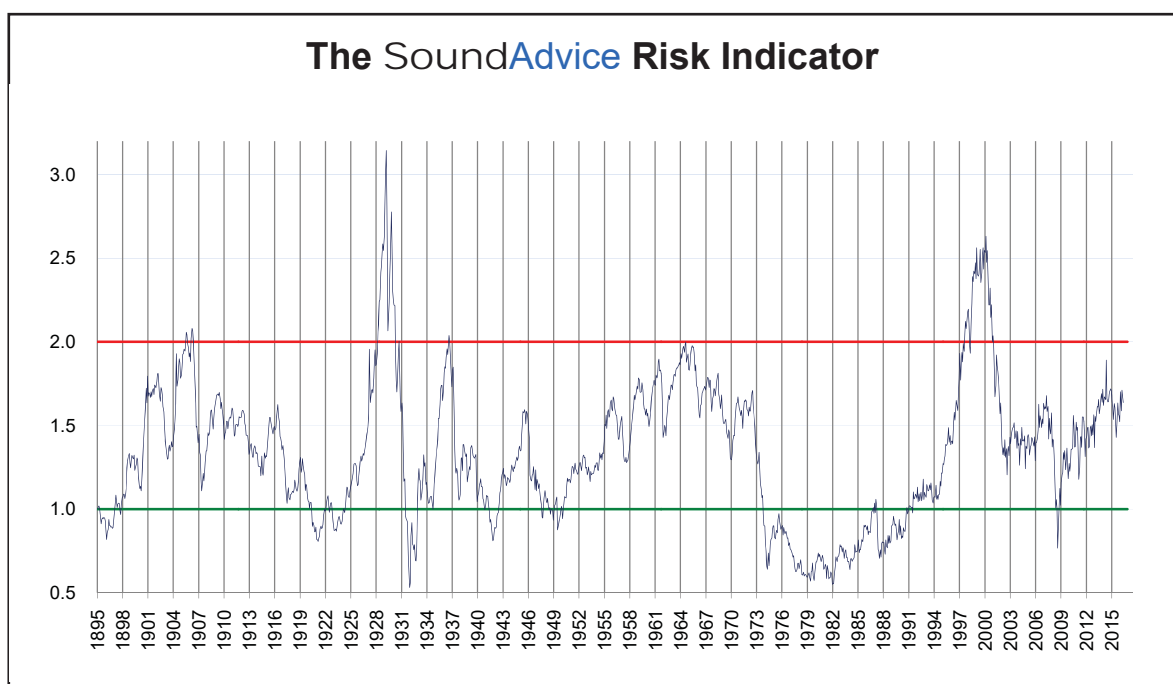
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a \$25,000 investment would have grown to \$13.9 million in stocks and to \$1.6 million in houses.

But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$552 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

The latest reading for the SoundAdvice Risk Indicator is 1.78. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Risk Indicator and its track record.



## Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

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

When the SoundAdvice Diffusion Index of **LEADING Indicators** drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the soft economy is providing an atmosphere for stable or declining interest rates.

This Diffusion Index gave us a zero reading in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

The SoundAdvice Diffusion Index of **LAGGING Indicators** gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reading reveals that the US economy is strong enough to put upward pressures on interest rates.

We have been operating under a "Caution" signal since the June 2015 release of the May lagging economic indicators.

The SoundAdvice Diffusion Index of **LAGGING Indicators** was **66.7 percent** in February (the most recent data).

Our next signal will come from the SoundAdvice Diffusion Index of **LEADING Indicators** when it drops to zero. The latest reading for February was **66.7 Percent**.

### Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 3.4 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.1%		3.4%

See *The Science of Making Money in the Stock Market* for a complete explanation of the SoundAdvice Diffusion Indexes and their track records.

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