

Words With Feds



Our portfolio is up by 8.7 percent so far this year, and the market is up 2.2 percent as measured by the S&P 500. We are off to a good start, especially in comparison to the market.

-- Gray Emerson Cardiff

A few days ago, Janet Yellen gave her semiannual testimony to Congress. As usual, the investment community was hanging on every word, looking for hints as to when interest rates will begin to normalize. Low interest rates have been pumping up stock and bond prices for many years, and a change in interest rate trends will change the investment landscape and impact all of our investments.

Our reliable Diffusion Index of Leading Indicators (page 11) tells us when the economy is strong enough to start pushing up interest rates. It first warned us in 2012, and then with a string of warnings in 2014. However, interest rates have remained low under the pressure of the Federal Reserve's extremely expansionary monetary policy which began with a zero interest on the Federal funds in late 2008 to bail out the economy from the meltdown. With the economy approaching full employment, and the Federal funds rate still at zero, it is only a matter of time until the ascent of interest rates begins. The only question is when.

A key word in the Fed's public statements has been "patient" in describing the Fed's posture regarding normalizing interest rates. However, Yellen told the Senate Banking Committee that the Fed's rate-setting policy committee will likely removing the word "patient" in describing its approach to rate hikes, then entering a phase in which rate hikes are possible at any meeting. She said when the word "patient" disappears it means the Fed will merely have

full flexibility to act if it judges the economic data warrants it.

For several months, the Fed has been moving away from giving the forward guidance it has in the past so that it does not spook the financial markets with each tweak to the exact words in its policy statements. To that end, Yellen told Congress:

"If economic conditions continue to improve, as the committee anticipates, the committee will at some point begin considering an increase in the target range for the federal funds rate on a meeting-by-meeting basis."

Yellen reiterated that the Fed considers a 2 percent annual inflation rate as an indication of overall economic health and a time to return interest rates to normal levels without distorting household and business spending and investment decisions. She added that the central bank could raise interest rates before inflation picks up if it foresees price increases accelerating and the job market continuing to advance. Yellen told the House Financial Services Committee: "If we gain confidence and continue to see the labor market improving, we will consider still raising rates,"

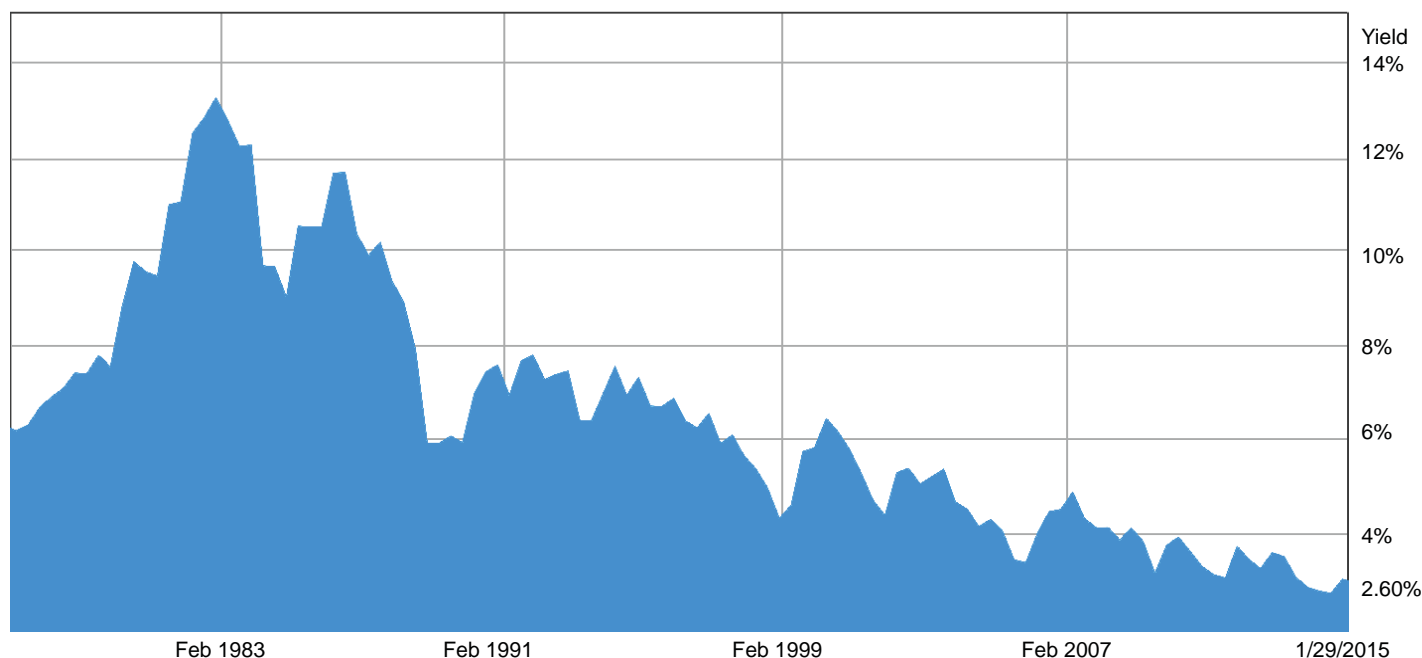
From this testimony and past official statements, we can see that the condition of the labor market is the key factor to the timing of a change in monetary policy. A key metric within the labor market watched by the Federal Reserve officials is the inflation rate of wages, or wage growth. The Fed believes that a sustained year-over-year wage growth rate of 3 percent is consistent with the overall inflation target of 2 percent. Accordingly, when we see 3 percent wage growth, we will be at a bright line for "normalizing" interest rates.

Yellen's testimony is only a few weeks after the non-farm jobs report for January which was strong and also reported large revisions for November and December, making the 3-month total the largest in 17 years. January's wage growth was 2.2 percent year-over-year. It is rising, but we are not there yet.

The "No-Brainer" ETFs

Our reverse ETFs are designed to benefit from the inevitable rise in long-term Treasury bond yields. We have dubbed these ETFs as "No-Brainers" because interest rates always rise during an economic recovery. The ascent has never

30-Year Treasury Bond Yields



been smooth and this time has proved to be no exception. These ETFs differ in the amount of leverage used:

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.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance.

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds with an average maturity length of close to 27 years. The prices of our No-Brainer ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

The chart above shows the yields of long-term Treasury

bonds over the last 30+ years. From this perspective, we can conclude that the only significant room for movement is upward. The Federal Reserve has not changed its official forecast which projects that the Federal Funds rate will increase from zero currently by 2.5 percent by the end of 2016. What is not clear is when the ascent would begin. Predictions vary from June, to sometime this fall, or even not until 2016.

We can project the movements of these ETFs based on the Federal Reserve's official forecast. Assuming Treasury bond yields will move in tandem with the Federal Funds rate, long-term Treasury bond yields will rise by 2.5 percentage points, from 2.60 percent today to 5.10 percent by the end of 2016.

This seems like a reasonable forecast because investors normally require a real return of 3 percent. As inflation returns to the Federal Reserve's target of 2 percent, long term Treasury bond yields should be in the vicinity of 5 percent. What is less predictable is what happens in the meantime.

A conservative forecast would be to assume that long-term Treasury bond yields decline throughout 2015 to the lowest point reached, a yield of 2.25 percent, and then increase to 5.10 percent by the end of 2016.

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As we have pointed out in past issues, the prices of these ETFs can erode over time because they decline slightly more than they increase with equivalent changes in bond yields. However, the erosion is minimal in comparison with changes caused by changes in bond yields.

Here is what would happen to each ETF:

TMV would decline to \$24 by the end of 2015, and then climb to \$99 by the end of 2016.

TBT would decline to \$42 by the end of 2015, and then climb to \$100 by the end of 2016.

TBF would decline to \$24 by the end of 2015, and then climb to \$37 by the end of 2016.

This forecast gives us perspective on the potential risks and rewards from here.

Financial markets rarely move gradually, or in an orderly fashion. It is highly unlikely that bond yields will rise in a gradual and orderly fashion once the rise begins. Trillions of dollars currently hiding in bonds are likely to be scrambling for the exits. As the US economy continues to heat up, and other economies around the world start to show vitality, US inflation is bound to heat up. Fear will likely consume the US bond market and the rise in bond yields is likely to be faster and to higher levels than is projected currently. At any rate, whether the rise is gentle or steep, we are bound to see substantial profits in these ETFs.

Although these ETFs deserve attention, they are only one of 24 positions in our model portfolio. However, the same macro forces, to which these ETFs are most sensitive, will be acting on the rest of our holdings as well. Here are updates on the rest of the portfolio in alphabetical order.

Portfolio Updates

Agrium (AGU) is up 20 percent this year, extending our profit to 735 percent. We include AGU in our portfolio because it has a broad mix of agricultural products and services that increases the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while worldwide population and per-capita income increases.

On February 23, Agrium announced fourth-quarter earnings after the market closed. Although earnings and revenues were down, the declines were not as bad as expected and AGU stock responded favorably.

The decline in revenue was due to a 2.1 percent decrease in its retail farm products segment along with a 12.9 percent drop in its wholesale fertilizer segment. Outages at two of its largest production facilities drove up operating expenses which was the primary culprit in the 38

percent earnings decline from the 2013 fourth quarter.

Agrium also provided its estimate of 2015 earnings to be in the range of \$7.00-\$8.50 per share, for a median of \$7.75. The consensus of the earnings forecast is \$8.97 per share for 2016. The annual dividend has increased to \$3.12 per share, giving AGU a 2.7 percent yield at the current price.

AGU remains a long-term buy. Based on the median forecast of \$7.75 for 2015 earnings, AGU is trading at a price/earnings (P/E) ratio of 15 which is still below the P/E for the S&P 500 of 17.5. A P/E of 18 in 2016 would put the stock in the vicinity of \$160 based on earnings of \$8.97 per share.

Associated Estates Realty Corp (AEC) is up 3.6 percent this year, extending our gain to 75 percent. What originally attracted us to AEC was the fact that this high-quality apartment REIT was selling at a substantial discount to the value of its net assets.

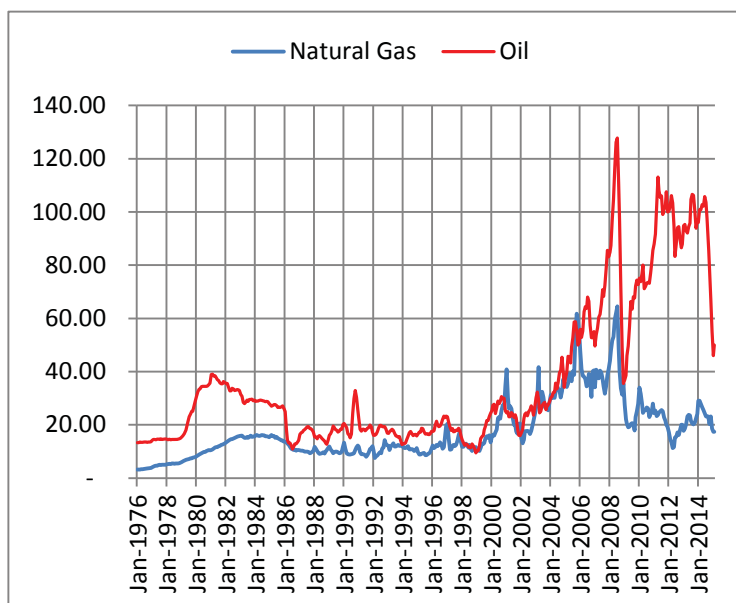
Based on the price of apartment REITs, the market is currently paying an average capitalization (cap) rate of 4.75 percent for the underlying portfolio of apartment properties. If we value the AEC's apartment portfolio at a cap rate of 4.75 percent, the value translates into a value of \$36 for AEC based on the fourth quarter financials released in February. We have been using a more conservative valuation and target of \$28.50 per share which is based on a cap rate of 5.7 percent. We began recommending AEC at \$15.40. We have been watching it slowly move up while collecting a nice dividend. AEC has recently increased its quarterly dividend from \$0.20 to \$0.21 per share.

It often takes the attention of an activist to unlock the value of a discounted stock. In this case the activist is the Land & Building Fund which has invested \$1.1 billion in AEC, and is launching a campaign to replace the board of AEC on the grounds that management has not been responsive to dialogues regarding unlocking shareholder value. In a gesture to avoid a proxy fight, in late February, AEC appointed Jon Fosheim, as its newest director. Fosheim was a co-founder of Green Street Advisors. AEC has also offered two new seats on the board for Land & Building Fund's proposed nominees.

We had a similar experience with Commonwealth REIT when a proxy battle caused the stock to climb more than 50 percent.

Boston Scientific (BSX) is up 27.5 percent this year, extending our profit to 78 percent. BSX's medical products are well suited for an aging population in the US. 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

The Cost of Energy Equivalents of Oil and Natural Gas



medical needs and reducing healthcare costs. BSX ended 2014 with 943 US patents.

In February, BSX reported a surge in fourth-quarter revenue, primarily from its largest division of cardiovascular devices, which increased by 9.6 percent. Earnings per share came in at 84 cents per share, an increase of 15 percent over the previous year.

Chesapeake Energy (CHK) is down 14 percent this year, trimming our gain to 5 percent. We originally added CHK to the portfolio because it was at a substantial discount to its net assets. The stock price was cheap because of low natural gas prices, poor corporate governance, and because it was in the midst of a financial squeeze. We could see all of these conditions were likely to be remedied, and indeed they were. Yet, we have another buying opportunity because of the recent crash in oil prices.

CHK is the second largest producer of natural gas and 70 percent of production volume comes from natural gas. Fracking for oil also produces natural gas as a by-product. The drop in oil prices will reduce fracking activity for oil which will also translate into a reduction of the supply of natural gas and bolster prices. With natural gas inventories currently below average levels, the market should remain steady which will help CHK weather the volatility in the oil markets.

In addition, as we point out below and the nearby chart illustrates, a substantial disparity still exists between the energy equivalent costs of oil and natural gas. In late December, Chesapeake finalized the \$5 billion sale of some of its assets outside of its core positions in the Marcellus and Utica shale. The company subsequently

announced that it will use part of the proceeds to buy back one billion dollars of CHK.

Fidelity Select Natural Gas Fund (FSNGX) is essentially unchanged this year, leaving our gain at 12 percent.

The precipitous drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At \$50 a barrel, that is the cost of 5.8 million BTUs. However, with a market price for natural gas close to \$3.00 for one million BTUs, 5.8 million BTUs will cost \$17.40 (5.8x\$3.00). So the same amount of energy is still available for 35 cents on the dollar, if it is in the form of natural gas rather than oil.

The nearby 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. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together recently, but remain substantially apart.

This difference still translates into an expanding natural gas industry, which makes this fund continue to be attractive. Natural gas is also cleaner-burning and more environmentally-friendly. These are both positive long-term fundamental forces acting on the natural gas market.

Ford (F) is up 5.4 percent this year, extending our gain to 14 percent. The stock price close is close to 10 times 2014 earnings which were depressed because of down time and preparation for 24 new or refreshed vehicles, including the all-aluminum F-150 truck which is likely to set a new industry standard. It weighs 700 pounds less and is projected to get close to 30 miles to the gallon. Growth prospects in 2015 look good. Pent-up demand due to an abundance of older cars still on the road should keep showrooms busy for the next several years. Low interest rates and plentiful credit make it easy to buy. In addition, low gas prices are particularly good for Ford trucks.

Ford is also making significant cuts by reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by 2016, which promises to save billions of dollars through economies of scale, and give Ford more agility to adapt to changes in demand.

Freeport-McMoRan Copper & Gold (FCX) also suffered along with the general decline in energy stocks because a significant portion of its assets are now in oil through the 2013 acquisition of oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. FCX is down 6 percent this year, extending our loss to 23 percent.

FCX is still primarily a copper stock. In 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America.

Copper is woven into the fabric of the world's developed economies, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. As the world's economies continued to expand into 2008, so did FCX.

Today's quantitative easing programs and expansive monetary programs around the world are bound to translate into expanding economies and increasing demand for copper. The stage is being set for another cyclical run in FCX.

The company's Vice Chairman of the Board agrees, as evidenced by his \$11,800,000 purchase of FCX in December at \$23.6 per share.

Hersha Hospitality (HT) has declined 3.6 percent this year, trimming our gain to 25 percent. Our principal reason for recommending HT was because the stock is selling at a discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the economic recovery. In addition, nearly a third of its major properties have been undergoing renovations and not producing their full income potential. HT saw the beginning of completed renovations and new acquisitions during the third quarter of 2014.

Hersha's development pipeline and portfolio recycling strategy in 2014, combined with a re-acceleration of corporate and leisure transient demand led to material improvement in the Company's revenue per available room ("RevPAR") quality. RevPAR at the Company's 46 consolidated hotels increased 8.6% in 2014. The average daily rate ("ADR") increased 4.9% while occupancy increased 2.75 percentage points to 81.3%.

We estimate the value of HT to be \$7.26 based on fourth quarter financials. We expect this value to increase as net operating income increases as new acquisitions and renovations come on line. Hersha's CEO, Jay Shah, also expects revenues to increase in 2015 for the same reasons.

ICON Energy Fund Class S (ICENX) has not suffered nearly as much as the drop in the price of oil. It declined 5 percent in 2014, and is essentially unchanged this year, leaving our profit at 4 percent. This compares to a drop of close to 50 percent in the price of oil.

In the past, this fund has achieved growth even during periods of declining energy prices, and this appears to still be the case. The changing landscape should provide opportunities ahead to capture values. For example, the stocks of oil and pipeline have also dropped along with the

price of oil, even though the cost and price of storage and transportation have little to do with the price of oil. ICON management looks for changes within the energy sectors to capture value, rather than simply depending on rising oil prices.

NCR Corp (NCR), formerly known as National Cash Register, 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. A catalyst for growth comes from the fact that approximately 90 percent of ATMs in the US still run on Windows XP which Microsoft just stopped supporting. That will translate into increased demand for NCR's ATMs.

In 2013, NCR increased its debt load to make two significant purchases -- Retailix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth which caused the stock to slide to its current attractive level. These acquisitions pushed NCR much farther along its path from a hardware provider to more of a software and services provider where profit margins are substantially higher, and should be contributing to earnings substantially.

Fourth quarter revenue reported in February was higher by 5.9 percent year-over-year despite currency headwinds which is evidence that the acquisitions are proving beneficial. On a constant currency basis, NCR expects revenue growth of 4-6 percent in 2015 and earnings of \$2.80-3.00 per share, which puts the stock price in the vicinity of 10 times earnings – a steep discount to the market.

Pfizer (PFE) is up 9 percent this year, extending our profit to 121 percent. PFE has an arsenal of new pharmaceutical products with more than 80 drugs in the development stage and 90 in the discovery stage. Among the most significant include *Palbociclib* for advanced breast cancer, a meningitis B vaccine, and *Xeljanz* for inhibiting the progression of rheumatoid arthritis. Pfizer's top selling drugs include *Lyrica* (for pain and fibromyalgia), and *Prevnar* vaccines (for pneumonia and other infections).

In February, *Palbociclib* received FDA approval two months ahead of schedule. The drug, trade-named "Ibrance", treats one of the deadliest forms of breast cancer by inhibiting two enzymes that promote the growth of cancer cells. UCLA was instrumental in testing the drug and said that Ibrance produced "ground-breaking results". It is expected to be a blockbuster for PFE, producing \$4 billion in sales by 2020, well ahead of potential competitor drugs from **Novartis** and **Eli Lilly**.

Retail Opportunities Investment Corp (ROIC) is essentially unchanged this year, leaving our profit at 71 percent. This REIT began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium.

At the end of February, ROIC reported strong fourth quarter results. The same-center net operating income increased 5.9 percent over last year's fourth quarter with rental rates increasing 17.9 percent. After signing 66 leases for 258,515 square feet, the portfolio finished at 97.6 percent occupancy.

The portfolio expanded in 2014 with \$414 million of acquisitions, expanding the portfolio by 27 percent. In January 2015, ROIC added another three shopping centers in southern California.

At the end of February, ROIC also raised the quarterly dividend again, to 17 cents per share, an increase of 6.3 percent. This follows the 2014 increase of 6.7 percent.

As new properties are added, along with tenant upgrades, funds from operations (FFO) are bound to continue to rise, along with the dividend, and push the price of this REIT upward. Meanwhile, ROIC pays an attractive dividend that lowers its risk profile.

Stryker (SYK) is essentially unchanged this year, leaving our profit at 133 percent. 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 cash-rich balance sheet and strong cash flow gives SYK avenues for continued diversified growth through acquisitions. Recent acquisitions include Small Bone Innovations (SBI) which has products for small bones and joints, Pivot Medical which has a platform of arthroscopic implants to efficiently access the hip with minimal incision, and Berchtold Holding which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems.

One of the most significant acquisitions was the MAKO Surgical acquisition, which put SYK in a leading position for robotic-assisted surgery and the potential for breakthrough innovations. MAKO has yet to make a significant impact. However, new products are planned for this year, including a new total knee product, which should begin to bolster growth.

The 2013 purchase of Trauson Products, China's largest manufacturer of orthopedic implants, also offers access to the Chinese market and broadens SYK's customer base.

Symantec (SYMC) is down this year by 1.9 percent, trimming our profit to 55 percent. If there ever was a more certain growth industry, protection from cyber espionage is it. SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. Nearly all of the Fortune 500 companies are Symantec customers.

Fourth quarter earnings announced in February were \$0.53 a share and ahead of expectations. Revenue from security products was up 20 percent, and up 5 percent from the electronic storage sector.

By the end of this year, SYMC will spin off its relatively small storage business as a tax-free distribution of a new publicly traded stock to SYMC shareholders. The split will allow both companies to be more competitive and responsive to their respective industries. The spin-off will make the balance of SYMC a more attractive acquisition to large I.T. companies because SYMC is currently trading at a low valuation, has a strong balance sheet, and has good cash flows and margins.

Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund) (the symbol is still HQL) is up 11 percent this year, extending our profit to 106 percent. This Fund is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

This trend should continue as the population ages and spends more on healthcare as they get older. Healthcare and biotechnology sectors have benefitted in recent years from the approval of many new products and drugs that actually make fundamental improvements rather than merely addressing symptoms or side effects associated with horrible diseases. HQL's largest holding, Gilead Science serves as an example. Gilead's treatment of Hepatitis C (Sovaldi) is one of the best drug launches ever. Other examples that were approved in 2014 include novel drugs to treat diabetes, idiopathic pulmonary fibrosis, psoriatic arthritis, melanoma, lung cancer, as well as specific forms of lymphoma and leukemia.

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.

Tetra Tech (TTEK) is down 4.7 percent this year, trimming our profit to 66 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet including \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$1.87 billion in signed contracts to clean up military bases across the US. TTEK recently announced a two-year, \$200 million share repurchase program which will enhance earnings.

Third Avenue Value Funds have a similar approach to ours because management is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams to come up with their estimates of intrinsic value. Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

Third Avenue Real Estate Value Investor Fund (TVRVX) is up 3.8 percent this year, extending our profit to 22.4 percent. This fund is replete with stellar values substantially below NAV with strong growth prospects.

In the quest for value, Third Avenue management is also constantly assessing risk. As interest rates have fallen to historically low levels globally, the cash yields on real estate (capitalization rates) that investors are satisfied with have also fallen to record lows which has led to record high property prices in most major markets. In considering the likelihood of rising interest rates in the months and years ahead, management recently reduced its holdings of securities that have been bid up in price by yield-seeking investors, such as REITs whose tenants have long lease terms, increased holdings of well-financed companies trading at discounts to net asset value (NAV), real estate companies operating with shorter lease terms, such as apartments and hotels, as well as real estate-related companies that would earn higher profits in a higher

interest rate environment, such as US banks.

Last year was a stellar year for REITs and REIT funds. Although this fund out-performed the S&P 500 last year by a substantial margin in 2014, its performance was below the average REIT fund. Because of its attention to value, TVRVX will shine during years when REITs in general do not. In case 2015 turns out to be one of those years, we will be glad we have TVRVX.

The comparison of TVRVX to other REIT funds is not totally fair because TVRVX has a number of distinguishing characteristics. TVRVX is more of 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 looks for opportunities in different points of a real estate company's capital structure by investing in senior debt in addition to a company's equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities in distressed times.

Third Avenue Small-Cap Value Investor Fund (TVSVX) is up 4.2 percent since we introduced it last year. This fund 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 compound 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.

Small-cap stocks perform better than large-cap stocks over the longer term because 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 profitable. Not only do small caps perform better over the long run, they generally benefit strongly from a recovering economy. In December, TVSVX paid a large long-term capital gain distribution of \$4.95 per share and a long-term capital gain distribution of 65.54 cents per share, for a total distribution of \$5.61 per share.

Transocean (RIG) has been hammered by the sharp drop in oil prices. In February, RIG decided to cut its dividend by 80%, from \$3.00 to 60 cents per share. This was not a surprise. In our January 2015 issue of *Sound Advice*, we said the following:

"The low price of the stock and the extremely high current yield indicates that the market believes the dividend will be sharply reduced or even eliminated ... For

the longer-term security of the Company, the uncertainty in the oil market is likely to prompt management to prioritize its debt prepayment over at least part of the dividend. Because uncertainty is also the most destructive force on stock prices, the announcement of a reduction would likely mark the bottom for RIG.”

The current 60 cent dividend, which is not likely to be lowered in the foreseeable future, is a solid 3%+ yield. This puts a floor in the vicinity of the current stock price because the yield is now dependable and in-line with the industry. Any substantial drop in the stock price from here would cause the yield to increase materially, which would be out of line with the industry.

The reduction in the dividend helps the long-term growth potential of the stock price from here because it strengthens the company’s balance sheet. The approximate \$900 million in savings can go toward debt reduction and reinvestment in the company, both of which help to preserve the company’s investment grade rating.

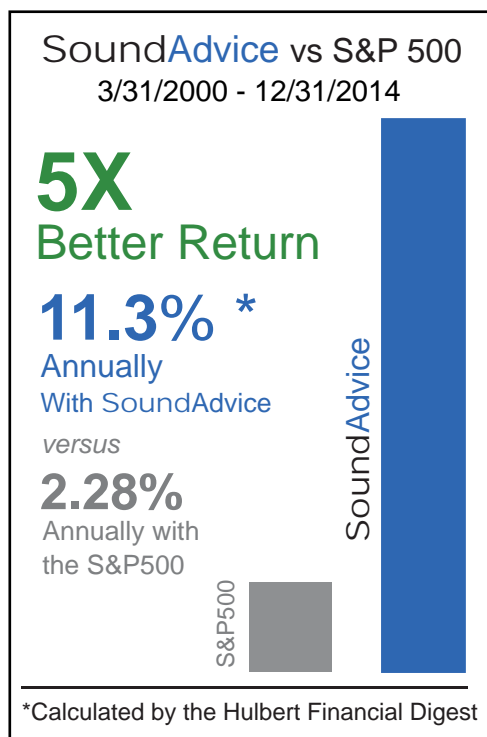
Along with the dividend reduction, it was announced that CEO Steven Newman is stepping down, and Ian Strachan, Chairman of the Board, will serve as interim CEO. We do not view this as a particularly negative development. Mr. Strachan is well-qualified and highly experienced. Often new leadership will bring fresh energy and a new era to a company.

Also adding to long-term growth potential is the fact that the west Texas (WTI) price of oil is below production costs for shale producers. The most significant production lies in the most expensive areas, including the Marcellus Dry shale at \$54. Closer to \$60 is in the Eagle Ford, Bakken, and California shale. Rising above \$60 is in the Permian, Wolfcamp, Bone Springs, and Utica shale. Prior to the oil price decline that began last year, these areas accounted for approximately half of US oil production and were the primary contributors to the glut. Now however, as the price of oil languishes in the vicinity of or below these costs, US production is bound to diminish. Over the long-run, less production on land from shale means more production and demand for RIG’s deep-water drilling platforms.

Vanguard REIT Index Investor Fund (VGSIX) was recommended last month because it reflects the REIT industry. It produced a return of 30.31 percent in 2014. As an alternative, the **Vanguard REIT ETF (VNQ)** can be used, which produced a slightly better return of 30.41 percent in 2014. The performances of both are

substantially identical during the last 3, 5, and 10 years. VNQ trades like a stock and is purchased through your broker who will charge a commission.

VGSIX can be purchased directly from Vanguard (800-841-7999) with no fee, or through your broker who may charge a fee. If you are investing \$10,000 or more, the **Vanguard REIT Index Fund Admiral Shares (VGSIX)** is the same fund except with a lower expense ratio of 0.10 percent (versus 0.24 percent with VGSIX). VNQ also has the same low expense ratio of 0.10 percent.



The performance of all three choices should be above-average REIT performers because most funds do not perform better than the averages over the years, and REITs usually out-perform the market.

Xerox (XRX) is down 1.4 percent this year, trimming our profit to 67 percent. We have been recommending XRX because it has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The strongest growth is coming from the expansion into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

XRX delivered strong profit and cash flow in 2014 with encouraging growth throughout the year. Most importantly, revenue from services improved through the year along with improved margin performance. Document Outsourcing revenues climbed over \$1 billion which included a multimillion-dollar contract late in the year with the Government of Canada.

XRX is focused on enhancing its services offerings, with a goal of \$900 million in acquisitions in 2015. Toward this end, earlier in the year XRX purchased Intrepid Learning Systems which educates and trains a client’s employees with the latest skills and knowledge to improve their business performance.

Management’s goal this year is to return \$1.3 billion to shareholders through share purchases and dividends, which is close to 10% of the company’s market cap. The share buy-backs have been a significant reason for this stock’s out-performance in recent years, and that trend should continue.

Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 23.95	3.51%	\$ 27.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 6.71	3.58%	\$ 7.80	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.75	3.58%	\$ 19.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 32.58	1.35%	\$ 34.00	BUY
Vanguard REIT Index Fund	VGSIX	800-841-7999	\$ 27.70	1.29%	\$ 35.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	\$ 115.53	2.70%	\$ 110.00	BUY
Ford Motor Company	F	NYSE	\$ 16.34	3.06%	\$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 21.63	5.78%	\$ 27.00	BUY
NCR Corp	NCR	NYSE	\$ 29.41	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 34.32	3.03%	\$ 35.00	BUY
Stryker Corp.	SYK	NYSE	\$ 94.75	1.12%	\$ 97.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 25.43	1.10%	\$ 25.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 23.44	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.65	1.83%	\$ 14.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 16.68	2.10%	\$ 26.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 32.05	1.03%	\$ 34.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 14.31	0.63%	\$ 20.00	BUY
Transocean	RIG	NYSE	\$ 16.13	3.72%	\$ 25.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 16.90	0.00%	\$ 18.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 28.05	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 24.34	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 43.15	0.00%	\$ 65.00	BUY
Symantec	SYMC	NASDAQ	\$ 25.16	2.38%	\$ 27.00	BUY
Teklka Life Sciences Fund	HQL	NYSE	\$ 28.10	0.00%	\$ 29.00	BUY

Notes to the table:

Prices are as of 2/27/2015. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

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, we assume another \$10,000 is invested again in that position.

If you are investing in the portfolio for the first time, we believe your performance will be enhanced by deferring purchases in positions that are not below our "Buy" limit.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

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.

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 underperforming 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 \$12.2 million in stocks and to \$1.6 million in houses.

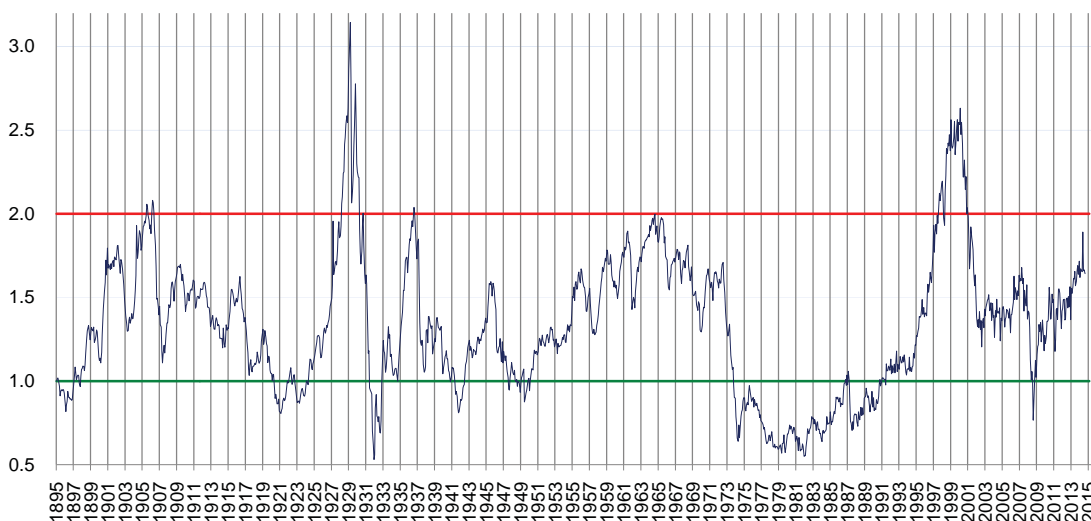
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$486 million, or 39.7 times more money—the 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 SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.64. This reading reveals that stock prices are substantially 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 Turbulent Markets* for a complete explanation of the SoundAdvice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

To construct our 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 economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The SoundAdvice Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 67.7 percent.

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 which reveals that the economy is about to put upward pressures on interest rates, and to move to a cautious approach.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of the Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100 percent for the fourth month in a row in June 2014 which tells us that the economy has become strong enough to push up inflation and long-term interest rates along with bond yields. It registered 33.3 percent in January.

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 34.4 percent. During "Caution" signals, the S&P 500 increased an average of 2.9 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
Ave +/-	34.4%		2.9%

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

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