



Editor, Gray Emerson Cardiff

Hulbert Financial Digest recently did a study on advisors that “shine in bear markets”. Below is an excerpt.

“...If your goal is to beat the market over the long term — and, if you’re like most investors, this is the Holy Grail of your investment life — then bear markets play an essential role in helping you attain it....wise sages tell us to never confuse brains with a bull market. Advisers can look good when the market is going up even when their success is due to little more than dumb luck. Genuine ability is more likely to become evident in a bear market.

With that thought in mind, I queried my Hulbert Financial Digest database for advisers who did better than a buy-and-hold strategy in the 2007-2009 bear market. I narrowed the list further by focusing on only those who also beat the market during the bull market that began in March 2009.”

There were 10 that emerged from Hulbert’s query, and *Sound Advice* was one of them. Hulbert then asks:

“Are there any investment traits that those advisers hold in common? One is that most of them focus on stock selection rather than market timing. That doesn’t necessarily mean that market timing should be avoided, of course. But it suggests you don’t have to engage in market timing to beat the market over the long term.

Another trait: The stocks they favor tend to be nearer the “value” end of the value-versus-growth spectrum. During bear markets, those stocks’ underlying value should cushion them from the huge losses often incurred by high-flying growth stocks.

So you don’t automatically have to go to cash even if you think a bear market is starting. Careful and intelligent stock picking, with a focus on long-term value, can also work.

Such an approach has an added bonus as well: If forecasts of a bear market turn out to be a false alarm and the market soon turns up, the stocks picked by such advisers should do well then too.”

The Big Picture

Last month we introduced the MCAP/GDP ratio. MCAP is the total capitalization of the stock market (stock prices of all publicly traded companies multiplied by their respective amounts of shares outstanding). The GDP is the gross domestic product of the US. This is one of the best “big-picture” indicators. When this ratio is high, stock prices are also dangerously high.

The current ratio is currently 1.27. To furnish the context, this ratio rose above 1.2 in the late 1990s prior to the 2000-02 bear market that took stocks down nearly 50 percent. This ratio recovered, along with the stock market, and then rose above 1.1, just prior to the 2008-09 bear market which took stocks down nearly 50 percent again. According to this indicator, stock prices are currently dangerously high today.

Our *Stock Market Risk Indicator* (page 10) is also climbing, reaching 1.89 for the latest reading. A reading above 2.0 has historically indicated stock prices are dangerously high. An additional warning has come from our *Diffusion Index of Lagging Indicators* (page 11).

Although stock prices are high and our trusted indicators are telling us to be careful, we are cautiously bullish for the near-term. The Federal Reserve is continuing to hold down short-term interest rates, and inflation is still below the Fed’s target of 2.0 percent, thanks primarily to declining energy prices and soft economies elsewhere in the industrialized world.

Last month the Bank of Japan (the counterpart to our Federal Reserve), announced that it will boost its quantitative easing (QE) program by purchasing its sovereign bonds to the tune of 15 percent of its GDP annually. On a relative basis, this new asset purchase program is substantially greater than the Federal Reserve’s QE programs, and greater than any attempted by other major central banks.

In November, China lowered its key interest rate to stimulate its economy.

The Japanese and Chinese moves are putting new pressure on the European Central Bank (ECB) to step up its stimulus efforts. Standing in the way is Angela Merkel, who is being referred to as “Hoover in a pants suit”, reminiscent of Hoover who wanted to tighten up during the 1930s depression in order to prevent the sins of the past from recurring. Remarkably, the yields on European sovereign bonds already have dropped sharply. However, as the rest of the developed world stimulates their respective economies, and as the euro currency continues to fall, the ECB will not have a choice but to apply more stimuli.

As long as world interest rates remain low, the backdrop is bullish for stocks. Of course, this is not a permanent situation. Eventually, stimulus leads to economic vitality, which in turn, leads to rising inflation and interest rates.

We have positioned the *Sound Advice* portfolio for an improving US economy and the increasing inflationary pressures and rising interest rates that an economic expansion ultimately fuels.

Our REITs, real estate stocks, and funds have been steady performers and are bound to be net beneficiaries as the US economy continues to grow. When interest rates start pushing up mortgage rates, it will be as a result of an expanding economy and the corresponding increases in rental rates more than compensate. These, along with our other hard-asset stocks and funds, should also benefit from rising inflationary pressures.

Although our “No-Brainer” ETFs have fallen with bond yields this year, they are bound to be explosive as interest rates rise. (See page 5).

The recent decline in oil prices have pulled down our energy-related stocks and mutual funds. However, ultimately they are bound to bring attractive profits because energy is woven into the fabric of all developed economies and subject to worldwide demand.

We always emphasize value, but when stock prices are generally high, sticking to value is exceedingly important. Here are updates on the individual positions of our portfolio, in alphabetical order.

Portfolio Updates

Agrium (AGU) is up 8.6 percent this year, extending our profit to 608 percent. AGU has a broad mix of agricultural products and services that are poised to benefit from growing demand as arable land continues to disappear around the world and the need for higher food production per acre increases. Growth is also bolstered by an expanding worldwide population along with increasing per-capita income.

In November, Agrium announced third quarter earnings of 17% higher than the comparable quarter last year, due primarily to the addition of the Viterro business acquired in October 2013 along with higher volumes and prices in nitrogen and phosphate fertilizer products.

In November, AGU also announced a 4% increase in the dividend to \$0.78 per share for an annual rate of \$3.12. After the 15 percent Canadian withholding tax, the net dividend is \$2.65.

As we reported last month, ValueAct Capital, a San Francisco-based hedge fund manager, recently acquired 5.7% of AGU and is trying to convince management and the board to implement strategies to optimize shareholder value.

This is how JANA Partners started its full proxy battle aimed at increasing shareholder value by \$50 per share. JANA's primary contention was that Agrium's retail business would attract a higher valuation as a separate company than under the current conglomerate structure.

Attention from activists are generally positive for stock holders. JANA's proxy battle caused AGU to climb from \$80 to \$115. This time, AGU jumped 8 percent on the day ValueAct announced its acquisition of Agrium stock. In any case, the weeks ahead should be positive. This is also confirmation that others also think that AGU is an under-valued stock.

Associated Estates Realty Corp (AEC) is up 44 percent

so far this year, extending our gain to 64 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.

It often takes the attention of an activist to unlock the value in a discounted stock. In this case the activist is the Land & Building Fund which has invested \$1.1 billion in AEC, and is looking to make a profit.

On November 18, Jonathan Litt, CEO and founder of Land & Building Investment Management, announced launching a campaign to replace the board of AEC on the grounds that management has not been responsive to dialogues regarding unlocking shareholder value. The stock jumped 8.7 percent on the day of the announcement.

Jonathan Litt is known as an activist REIT investor, and evidently sees the substantial discount we do. Litt objects to AEC's issuance of new stock in recent years at a price that is at a discount to the company's net assets. In connection with the announcement, Litt said,

“The last thing you do when you're trading at a discount is issue stock and buy or build new properties. What they should have been doing all along these years is selling properties and buying back stock.”

We had a similar experience with Commonwealth REIT. We recommended it while it was also trading at a steep discount to the net asset value of its real estate. Activists went after that discount as well. After investing heavily in the REIT, they mounted a successful campaign to remove the board in a proxy fight. On the announcement and during the proxy battle, the stock climbed more than 50 percent to close to its net asset value, at which time we took our handsome profit.

We look for further advances in the price of AEC.

Boston Scientific (BSX) is up 7 percent so far this year, extending our profit to 36 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 medical needs and reducing healthcare costs.

After a robust third quarter with revenue growing across all 7 of the company's business sectors, the future of BSX remains positive.

In addition to launching innovative and competitive products, along with receiving favorable recommendations from the FDA on some of its most significant cardiovascular products, BSX continues to repurchase its shares. Also adding to growth prospects is the expansion into emerging markets, particularly India and China. Over the next several years, \$150 million is budgeted to build a local manufacturing operation in China.

Chesapeake Energy (CHK) is down 24 percent this year, trimming our gain to 26 percent. CHK is the second largest producer of natural gas and pioneered the use of fracking

technology, a process of pumping liquids into shale under high pressure to recover oil liquids and natural gas that would not otherwise be recoverable. We 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. Natural gas prices have recovered, the company has new leadership, and billions of assets have been sold to remedy the financial problems.

In November, Chesapeake reported strong third quarter earnings. Although marginally below those of one year ago, the earnings report was above the expectations of Wall Street and even the company. For the first time since the board began transforming the company in 2013, management is openly optimistic about CHK's future for several reasons. After massive asset sales, the balance sheet is now a source of strength. Costs have been cut and the company now runs efficiently. Costs are being managed such that only those expenditures are made that will lead to increases in shareholder value. These financial improvements give the company the ability to more fully exploit its high-quality natural resource assets. It is on this basis that, although oil and natural gas prices have declined, Morningstar increased its fair value of CHK from \$37 to \$42 per share on November 21 which is double the current price of the stock and confirms the value we see in CHK.

Fidelity Select Natural Gas Fund (FSNGX) is down 1.7 percent this year, trimming our gain to 28 percent.

Our primary reason for recommending this fund is simply that natural gas provides energy vastly cheaper than other sources of energy, which translates into an inexorably vibrant and expanding natural gas industry. This is still the case, even after oil has dropped sharply in recent months while natural

gas prices have held relatively steady.

One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. With one barrel of oil at \$66, that is the cost of 5.8 million BTUs of energy. On the other hand, with a market price for natural gas at \$4.00 for one million BTUs, 5.8 million BTUs will cost \$23.20 (5.8x\$4). So the same amount of energy is available for 35 cents on the dollar -- if it is in the form of natural gas.

To illustrate the point, we continue to display the historic relationship between the costs of these two forms of energy in the chart below because it demonstrates that today's disparity is not a normal situation.

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 two forms of energy are closely aligned, and are now moving closer together again.

Ford (F) was added to our portfolio on November 11 through our e-mail update called "*Ford Tough*" when the price was \$14.32 per share. The 20 percent dip in the stock price in recent months made it timely, and brought it close to 10 times 2014 earnings. The stock has crept up since that initial recommendation, but is still well below our buy limit.

We believe 2014 earnings are depressed because the new F-150 debut cost Ford about 13 weeks of production down time. Also dragging earnings this year is the preparation for 23 other vehicles that are either new or significantly refreshed. Ford's capital spending is close to \$7.5 billion in 2014 which is \$900 million more than in 2013.

Another drag on earnings came from overseas, the source of 42 percent of Ford's earnings in 2013.

Growth prospects from here look good for several reasons. For the last 37 years, F-Series trucks have been the best-selling vehicles in the US. In November, Ford started production on its all-aluminum F-150 truck that 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.

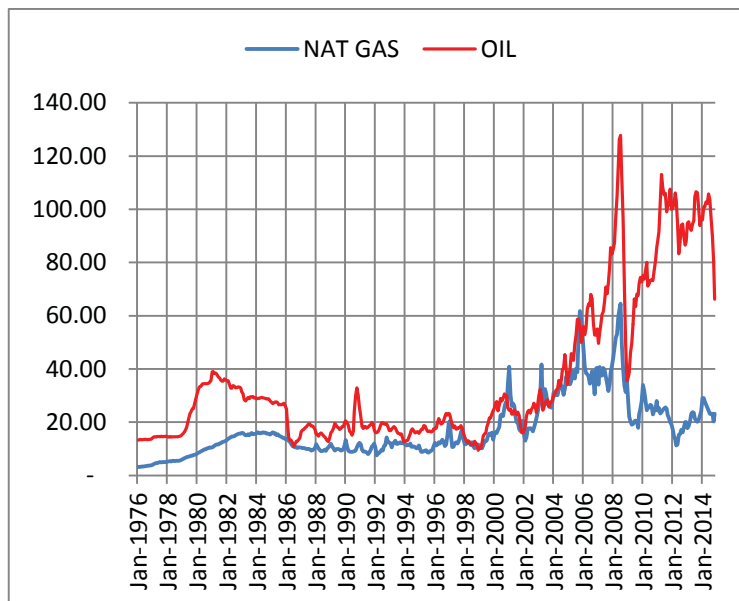
As the new F-150 trucks hit the showrooms, along with other new and innovative models, the stage will be set for significant revenue growth beginning next year. Ford's fuel-efficient models, the Fiesta, Focus, and Fusion, have been very well received and should continue to do well.

In addition, the US auto industry is subject to pent-up demand for the next several years because of an historically high abundance of older cars still on the road. Low interest rates and plentiful credit make it easy to buy. In addition, low gas prices are particularly good for Ford trucks.

At current depressed economic levels, the downside from Europe is limited and there is substantial room for growth. During the second quarter, Ford saw its first profits from Europe in 3 years. Ford also saw record profits from Asia with wholesale volumes in China up 26% from the prior year.

On the expense side, Ford has been making significant cuts by reducing the number of platforms it uses to produce

The Cost of Energy Equivalents of Oil and Natural Gas



its models. The number of platforms is currently down to 15 from 27 in 2007. In 2016, Ford expects to have only 9 platforms, and the ultimate objective is 8 platforms. As a result of the reduction of platforms, development costs are dropping by billions of dollars through economies of scale, and Ford has the ability to adapt more quickly to changes in demand.

The consensus is that Ford's earnings will be 35 percent higher in 2015 alone. Morningstar's current fair value estimate is \$23 per share.

We also believe Ford is a solid value with limited downside. The dividend was increased this year again to \$0.50 a share for a current yield of close to 3.5 percent. A solid dividend limits the downside. Any quality problems on the new F-150 could be detrimental to Ford's bottom line. However, the new truck has been tested more than any other vehicle in Ford's history.

The Ford family has 40% voting power through ownership of Class B shares. As outside investors, we are investing in the Class A shares, each of which carries one vote. Although the Ford family has a grip on control, its large ownership aligns its interests with ours as outside shareholders.

Freeport-McMoRan Copper & Gold (FCX) jumped on the day that China lowered its key interest rate to stimulate its economy which accounts for 40 percent of global demand for copper. Copper is woven into the fabric of every developed economy, 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. In March 2007, FCX purchased Phelps Dodge and became the world's largest copper producer in North America. As the world's economies continued to expand into 2008, so did FCX.

Since the Phelps Dodge transaction, FCX has added substantially to its copper reserves and continues to have opportunities to add reserves because of its large resource base and ongoing exploration program.

The 2013 acquisition of substantial oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico is an added bonus both for earnings growth and stability.

Prices of FCX's primary assets, copper, energy, and to some extent gold, have been soft recently amidst slow economic growth outside the US. However, this condition is not a permanent situation. FCX offers a very attractive dividend yield with excellent long-term growth potential from its abundance of natural resources.

Hambrecht & Quist Life Sciences Fund (HQL) is up 29 percent this year, extending our profit to 83 percent. HQL is a closed-end fund which means that the price of the fund can vary from the value of the underlying net asset value (NAV) of the fund's holdings. Currently the price of HQL is close to a 5 percent discount to its NAV.

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. The biotech sector is projected to exceed the earnings of nearly all other sectors of the economy.

Gilead Sciences, HQL's largest holding, is the inventor of *Sovaldi*, a drug that cures Hepatitis C, and promises to be the most successful drug ever. Gilead also has promising remedies for HIV and AIDS, along with products for cardiovascular needs, macular degeneration, cystic fibrosis, and influenza.

HQL also holds a variety of biotechs, all of which have promising products and treatments for a wide variety of dreaded diseases. These include Celgene, Biomarin Pharmaceuticals, Pharmacyclic, Biogen Idec, Medivation, Amgen, Regeneron Pharmaceutical, Puma Biotechnology, and Sangamo BioSciences.

Hersha Hospitality (HT) is up 36 percent since our recommendation in December 2013. Our principal reason for recommending HT was because the stock was selling at a significant discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the economic recovery. On top of the stock selling at a discount to net assets, the net assets were low because 70 percent of its major properties were undergoing renovations and were not producing their full income potential. HT also had sub-par non-core properties at the time, which have now been sold and deployed into more productive properties.

The most recent third quarter was the first to see the early benefits of completed renovation and development projects. Revenues per average room (RevPAR is the vernacular) were up strongly in all geographic areas, ranging from, 9.5 percent in Manhattan to 17.7 percent in Boston. The west coast was up 15.4 percent.

Based on the most recent quarterly results, we value HT's NAV at \$7.49 per share. However, increases in the NAV valuation will occur as income from new acquisitions are realized along with increased income from completed renovations.

As a result of the cash flow growth so far from the ramp-up

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of strategic acquisitions and renovations, Hersha increased its quarterly dividend from \$0.06 per share to \$0.07 per share.

HT has an excellent risk/reward ratio. Risk is minimized with the stock below a currently depressed net asset value. The dividend is solid because it is well-covered by funds from operations (FFO). The yield is attractive and limits downside movement in the stock price.

ICON Energy Fund Class S (ICENX) is down 2 percent since we added it to the portfolio last year, even with the slide in oil prices. We added this fund to the portfolio because it takes energy to make everything, and especially large amounts to make the most vital materials and substances, such as chemicals, plastics, and to run data centers. The best time to invest is when demand is down, when the world economy is in a slump, or there is a temporary glut, both of which have added up to a 20+ percent decline in oil prices recently. Aside from the cyclical timing, above average investment returns can be earned over the long run. Over the last 10 years, the Energy Equity Index has produced superior investment returns to that of the S&P 500. That performance is because energy is in the fabric of the economy.

Most energy mutual funds have not been able to match the performance of the Energy Equity Index. However, this fund has out-performed the Energy Equity Index resoundingly.

Seven industries make up the sector (as represented by the S&P 1500 Energy Index): integrated oil and gas, drilling, equipment and services, exploration and production, refining and marketing, storage and transportation, and coal and consumable fuels. ICON management looks for changes within these sectors to capture value, rather than simply depending on rising prices. This fund has achieved growth even during periods of declining energy prices. The track record of this fund bears this out. The changing landscape should provide opportunities ahead to capture values.

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.

NCR is cheap because rapid earnings growth came to a halt in 2013, causing the stock to slide. The reason for the slowdown in earnings was because NCR increased its debt load to make two significant purchases -- Retalix, 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. However, these acquisitions have started to add to earnings and have 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.

In October, NCR took a temporary dip on earnings that were slightly below expectations. We recommended using the dip as a buying opportunity and the stock has since recovered. The company is expecting 2014 earnings expectations to be in the range of \$2.60 to \$2.70, which puts it close to 11 times 2014 earnings. Wall Street expectations are in the vicinity of \$3.00 for 2015 which puts the stock close to 10 times 2015 expected earnings. In either case, the stock is selling at a steep discount to the market and its peers.

No-Brainer ETFs are designed to benefit from the inevitable rise in long-term Treasury bond yields. They 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.

We have dubbed these ETFs as "No-Brainers" because interest rates always rise after a recession during the recovery. The upward path has never been smooth, and this time is proving to be no exception.

The Federal Reserve has been keeping interest low because US inflation is at bay, due mainly to the decline in energy prices and slow economic growth elsewhere, especially in Europe. However, just as they do in the US, low interest rates and energy prices will stimulate growth there as well. As economies around the industrialized world exhibit more vitality, along with mounting strength in the US economy, pressure will mount on the Federal Reserve to let US interest rates rise to normal levels, from the emergency levels established 5+ years ago to bail us out of the 2008-09 melt-down.

The Fed is now officially done with its massive quantitative easing (QE) Treasury bond-buying program, clearing the way for the normal forces of supply and demand to take over. With Treasury bond yields at historic lows, they can only go up from here.

As far as the timing is concerned, the best forecast we have to go on is still that of the Federal Reserve itself. The Federal Reserve's official forecast projects the benchmark Federal Funds rate will increase from zero currently to 1.2% by the end of 2015 and to 2.5% by the end of 2016. Beyond that, officials project that the Federal Funds rate could settle in at 3.75%.

At the very least, Treasury bond yields should move in tandem with the Federal Funds rate. That means long-term Treasury bond yields will rise from 2.91 percent today to 4.11 percent by the end of 2015, and to 5.41 percent by the end of 2016.

We can construct a model of these ETFs based on the

Federal Reserve's forecast. 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.

If we assume that the ascent in interest rates will not begin until the end of May, 2015, we would see these ETFs erode until then. As we have illustrated in prior issues, there is an erosion factor with these ETFs because they decline slightly more on downswings than they rise on equivalent upswings in bond yields, and the erosion factor is more pronounced with leverage. With bond yields at absurdly low levels, there is not much room for declines, but they could churn up and down, rising say, 5 basis points one day and declining the same amount the next. Based on history, this would be a high degree of churning and it would be unusually detrimental.

This churning would erode TMV's price the most, by 5.5 percent, because it uses the most leverage. TBT would erode 2.7 percent, and TBF would erode 0.86 percent. Then, this erosion would be followed by steady price increases in all three ETFs, along with rising interest rates.

TMV would rise to \$61.7 by the end of 2015, and to \$112 by the end of 2016 which is slightly more than three times its current price. The chart to the right shows the pattern, including the erosion until January.

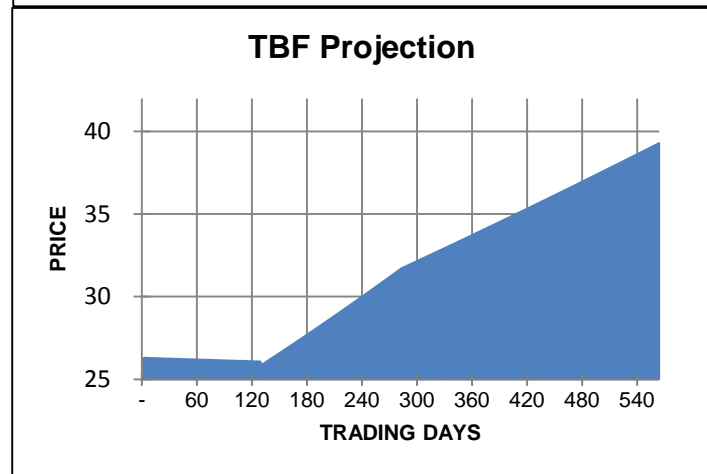
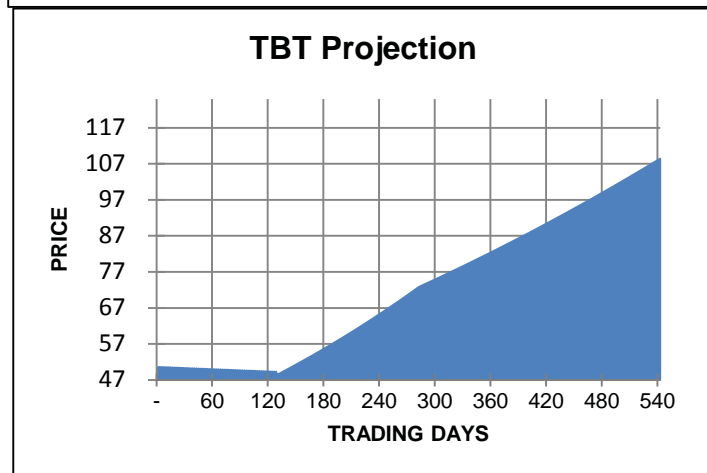
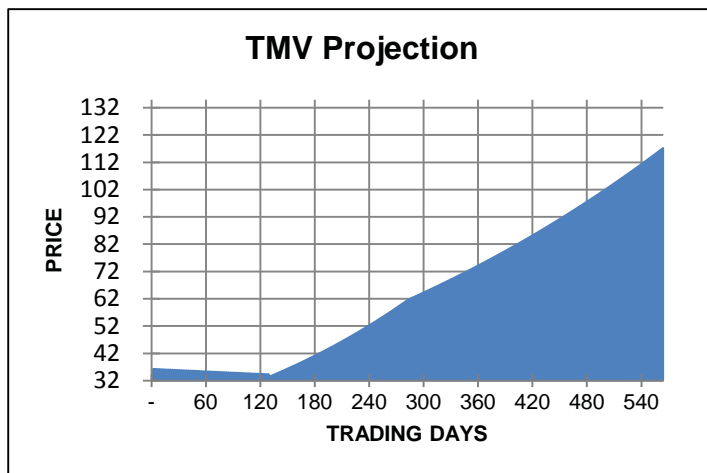
TBT would rise to \$72.8 by the end of 2015, and to \$108 by the end of 2016, which is slightly more than twice its current price. The chart to the right shows the pattern.

TBF would rise to \$31.7 by the end of 2015, and to \$38.7 by the end of 2016, which is 48 percent greater than its current price. The chart to the right shows the pattern.

While these ETFs are no-brainers after a recession because interest rates always rise, the ride has been rougher than we first anticipated. However, even though the Federal Reserve's forecast calls for a gentle increase over a long period, it would still push up the prices of these ETFs substantially, and demonstrates the profit potential.

We should also keep in mind that the Federal Reserve projects the "normal" Federal Funds rate to "settle in at 3.75%." That brings long-term Treasury bond yields to 6.82 percent assuming a tandem rise with the Federal Funds rate, and potentially larger profits for these ETFs.

It is worth noting that financial markets seldom move gradually, or in an orderly fashion. It is highly unlikely that bond yields will rise in a gradual and orderly fashion, in accordance with the Federal Reserve's gentle forecast. It is a safer bet to assume that the first whiff of rising interest rates will send trillions of dollars currently resting in bonds



scrambling for the exits all at once. 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 which will undermine the US dollar. What is likely to ensue will be a panic to get dollars out of a sinking asset. Fear and greed will likely consume the US bond market. That is usually how it works.

At any rate, whether the rise is gentle or steep, we are bound to see substantial profits in these ETFs.

Pfizer (PFE) is essentially unchanged this year, leaving our profit at 94 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on

its blockbuster drug, *Lipitor*. However, its future was brighter due to the 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).

The strongest revenue growth is coming from oncology products, led by *Xalkori* and *Inlyta*, and vaccines led by its *Prevnar* group of vaccines.

Lyrica is also growing rapidly and on track to be a blockbuster bringing in \$5 billion annually. The company has repurchased \$4.2 billion of its own common stock during the first 3 quarters of 2014, and is on track to purchase \$5 million in 2014. PFE is a good value with promising growth from a wide array of drugs and treatments. Its dividend is close to 3.5 percent.

Retail Opportunities Investment Corp (ROIC) is up 15 percent this year, extending our profit to 66 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.

The most recent quarter saw operating income nearly double that of one year ago. ROIC offers high-quality space as evidenced by its consistent 95+ percent occupancy and rising rental rates. As new properties are added, along with tenant upgrades, FFO is 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 up 25 percent this year, extending our profit to 128 percent. SYK is best known for its orthopedic devices for artificial knees and hips. SYK also provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products. 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 along with its strong cash flow, gives SYK multiple 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, Berchtold Holding which has a product portfolio of surgical infrastructure equipment including surgical tables and lighting systems. One of the most significant was the MAKO Surgical acquisition that put SYK in a leading position for robotic-assisted surgery and the potential for break-through innovations. 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.

Most recently, it was announced in November that SYK had made an offer in May for Smith & Nephew, a UK medical device concern. Stryker may structure the proposal as a so-called inversion which would move Stryker's headquarters offshore for tax advantages. However, since SYK made the offer, the US Treasury announced new rules in September aimed at discouraging tax inversions. Even without the inversion structure, the purchase would be accretive for SYK. Under UK rules, SYK must wait until December to make a further bid.

Symantec (SYMC) is up 12 percent this year, extending our profit to 60 percent. 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. Ninety-nine percent of Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

In November, SYMC announced earnings that were slightly lower than one year ago but higher than expectations.

SYMC has been buoyed by the October announcement that it will spin off its relatively small storage business as a tax-free distribution of a new publicly traded stock to SYMC shareholders by the end of 2015. This 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.

Tetra Tech (TTEK) is down 2 percent this year, trimming our profit to 77 percent. TTEK is a leading company in water technologies and environmental remediation with a healthy balance sheet with \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$2 billion in signed contracts to clean up military bases across the US. TTEK also provides energy efficiency and carbon management consulting which are bound to see growth under the new proposed carbon rules announced by the EPA which are aimed at reducing carbon emissions from power plants by 30 percent by 2030.

TTEK is restructuring by exiting its Remediation and Construction Management ("RCM") segment which carried additional risks and has not added significantly to cash flow. Going forward, TTEK will be focusing on two segments: Water, Environment and Infrastructure (WEI) will include TTEK's federal water, environment, and infrastructure businesses; and Resource Management and Energy (RME) will include oil and gas, energy, global mining, waste management, remediation, utilities, and international development businesses.

As TTEK opens its fiscal 2015 year with the 2014 calendar fourth quarter, the company announced its guidance for earnings in a range of \$1.55 to \$1.75 per share. TTEK also announced a

two-year, \$200 million share repurchase program which could add more than \$0.20 per share to earnings.

This year, TTEK initiated its first quarterly dividend of 7 cents per share for the second quarter and is buying back \$100 million of its common stock.

Third Avenue 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. 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.

Last October, we introduced the **Third Avenue Real Estate Value Investor Fund (TVRVX)** into our portfolio, and it has since grown 17 percent. It has led the pack of all real estate mutual funds during the last 3 years. This is still where the best real estate values can be found in a mutual fund. It is replete with stellar values substantially below NAV with strong growth prospects.

The **Third Avenue Small-Cap Value Investor Fund (TVSVX)** is up 2.7 percent since we introduced it earlier this year. This fund invests in companies with small capitalizations using the same value-oriented approach. 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 making decisions regarding a particular company, management evaluates the entire business enterprise, assesses the assets, and ascertains the NAV. From there, a credit profile is created to ensure that the company has the ability to meet its obligations, take advantage of investment opportunities, and survive financial storms.

Transocean (RIG) was introduced to our portfolio because of its low valuation and high yield. Needless to say, the sharp drop in oil prices in recent months has been a jolt to RIG and the industry. Third quarter earnings reported in November was better than expected but were still down from the previous quarter. Operating cash flow was up 38.7 percent over the previous quarter. However, fleet utilization slipped to 75 percent from 78 percent and revenue efficiency slid from 92.6 percent from 95 percent. Both of these declines reveal the trouble RIG is having with its older rigs.

One of the reasons for recommending RIG was its ability to sell-off its older assets to master limited partnerships (MLPs) at retail prices that exceeded those available on the open market. However, the sharp deterioration in the price of oil and the impact on the industry has stalled the prospects of forming MLPs. As a result, the company took a \$2.79 write-down due to a “non-cash good-will impairment charge caused by the deterioration of the market.”

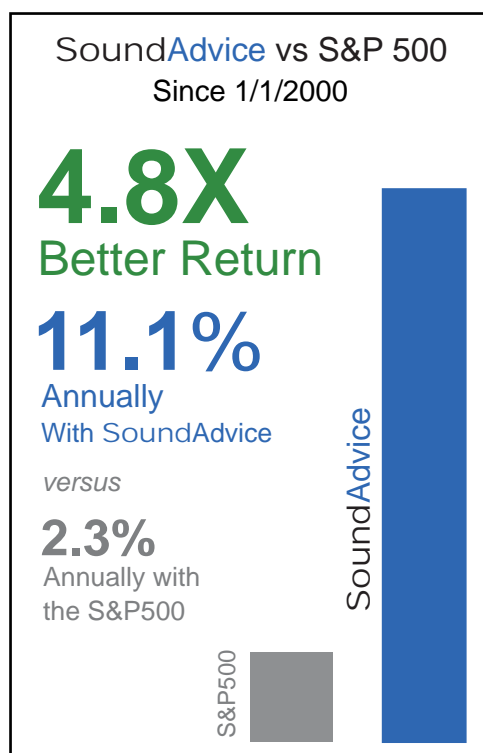
The change in the company's contract backlog was both good news and bad news. The bad news was that it declined from \$29.8 billion to \$23.6 billion. The good news is that there is still a backlog and that the company's most significant contracts last through 2016. The question becomes: Can Transocean weather the storm for the next year or two, by which time the oil market conditions will have stabilized?

The price of the stock says no. A dividend yield in excess of 10 percent is indicative that the market does not believe it will last. We saw a solid dividend when we recommended RIG, and the numbers from the latest quarter, which was an undeniable disaster, show that it still is. The net cash flow during the third quarter was still more than double the cost of the dividend.

Of course, further deterioration, which is anybody's guess, could jeopardize the dividend. However, a dividend cut may not hurt the stock price substantially because the market is already betting on it.

On a near-term basis, Rig could be presenting a great buying opportunity now. On a longer term basis, there is little doubt. While on-land fracking and other new techniques have added to supplies, the majority of oil still comes from deep-water drilling, and RIG is a premier provider of those platforms to the world's major oil companies.

USAA Precious Metals & Minerals Fund (USAGX) is essentially unchanged this year. When the economic recovery gets more traction, the money created in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities including precious metals.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 22.42	3.39%	\$ 23.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 7.41	3.24%	\$ 7.86	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.46	3.65%	\$ 18.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 32.47	2.03%	\$ 34.00	BUY
Diversified Growth						
Ford Motor Company	F	NYSE	\$ 15.73	3.18%	\$ 17.00	BUY
NCR Corp	NCR	NYSE	\$ 29.65	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 30.15	3.45%	\$ 33.00	BUY
Stryker Corp.	SYK	NYSE	\$ 92.91	1.14%	\$ 92.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 28.56	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.96	1.79%	\$ 14.50	BUY
Energy/Natural Resources						
Agrium	AGU	NYSE	\$ 97.42	2.72%	\$ 105.00	BUY
Chesapeake Energy Corp	CHK	NYSE	\$ 20.26	1.73%	\$ 26.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 37.06	0.89%	\$ 42.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 26.85	4.66%	\$ 35.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 20.69	3.58%	\$ 24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 27.18	1.03%	\$ 28.00	BUY
Transocean	RIG	NYSE	\$ 21.01	12.14%	\$ 35.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 12.98	0.15%	\$ 15.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 12.86	0.00%	\$ 14.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 35.44	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 26.09	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 49.80	0.00%	\$ 65.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$ 25.06	0.00%	\$ 26.00	BUY
Symantec	SYMC	NASDAQ	\$ 26.10	2.30%	\$ 26.00	HOLD

Notes to the table:

Prices are as of 11/28/2014. See our website for live pricing and buy limits:

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

Yields on funds may include capital gain distributions.

* Transocean (RIG) and Agrium (AGU) yields are net of the 15 percent foreign withholding tax.

Geopolitical tensions are a positive for precious metals because they are also safe haven assets. This fund will also benefit from inflation when the economy begins to overheat. USAGX is the best diversified way to invest in precious metals. It is the top-performing fund, and has constantly outperformed precious metal equities for ten years.

Xerox (XRX) is up 16 percent this year, extending our profit to 70 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 has been expanding by partnering with companies who need to outsource essential processes that XRX can do.

Document outsourcing is among the more obvious products XRX has to offer through its Managed Print Services. Twenty-three products were introduced in 2014 along these lines. The less obvious include XRX's Vehicle Passenger Detection System, which was used to enter into partnership with the University of Michigan Mobility Transformation Center to further develop tracking the movement of people and goods worldwide.

XRX has also been making synergistic acquisitions, including Consilience Software, a healthcare case management software provider used by government agencies to track cases from child welfare to disease management (including Ebola).

Xerox expects 2014 earnings to be in the range of \$1.11 to \$1.13 per share. 2015 earnings expected to range from \$1.11 to \$1.17 per share. At close to 12 times earnings, XRX is still cheap.

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 \$12.1 million in stocks and to \$1.39 million in houses.

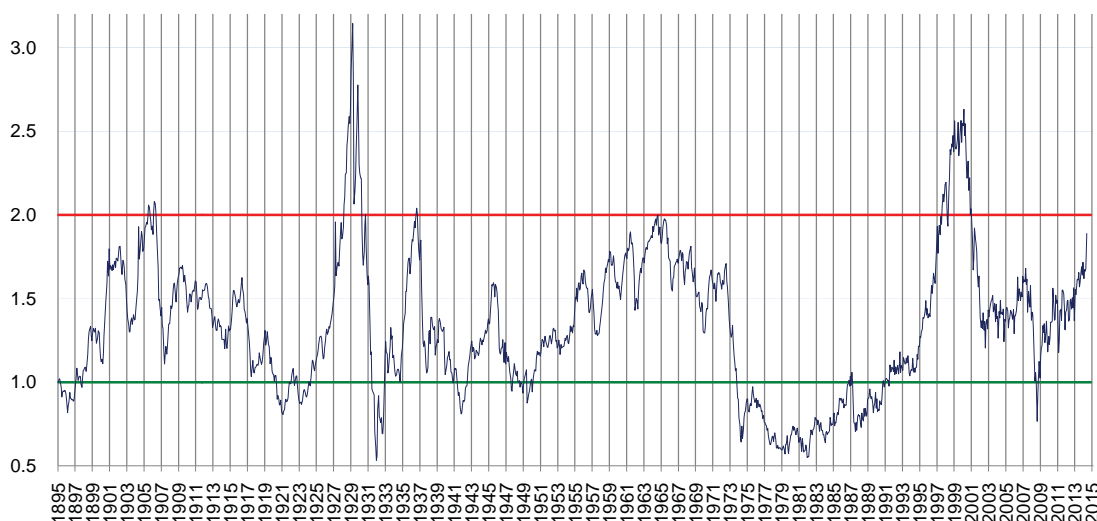
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$483 million, or 39.7 times more money—the 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 Sound Advice Risk Indicator is 1.89. 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 Sound Advice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



Business Cycles and Stocks: The SoundAdvice Diffusion Indexes

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

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

To construct our 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 66.7 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 66.7 percent in October.

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 2.7 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%		2.7%

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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