

## The Patient Fed



**Editor, Gray Emerson Cardiff**

For the fifth year in a row, *Sound Advice* made Hulbert's 2015 Honor Roll again as one of the best 12 newsletters having the best performance in both up and down markets since March 31, 2000. *Sound Advice* had the best performance of the 12 Honor Roll winners. According to Hulbert's independent tracking, *Sound Advice* produced an annual return of 11.3 percent. This is the second year in a row we occupied the #1 spot.

Hulbert says about the Honor Roll:

*"...is a list of newsletters that you likely will be able to live with through both thick and thin."*

*"It shouldn't be that difficult...But it is. A newsletter that consistently does well when the stock market is going up tends to be a big loser when the market heads south -- and vice versa. This in turn suggests that making it into the Honor Roll really means something..."*

Frankly, our #1 ranking in the 2015 Honor Roll was a bit of a surprise because 2014 was not one of our stellar years. Although we had nice gains in most of the portfolio, some of which we captured by selling during the year, our overall positive performance was dampened by declines in our energy-related stocks and reverse ETFs designed to benefit from rising bond yields. However, as we explain in this issue, our model portfolio is positioned to outperform the market in 2015.

Happy New Year!

**-- Gray Emerson Cardiff**

Interest rate movements are a powerful force on the direction of the stock market. That is why the exact words in the Federal Reserve's official statements can be very important. In her statement after the mid-December meeting, Chair Janet Yellen carefully chose the word "patient" to describe the Federal Reserve's approach to begin normalizing monetary policy by starting to raise interest rates. She said:

*"Based on its current assessment, the Committee judges that it can be patient in beginning to normalize the stance of monetary policy."*

Here is how the dictionary defines "patient" when it is used as an adjective: *able to accept or tolerate delays, problems, or suffering without becoming annoyed or anxious. "Be patient, your time will come".*

With the normalization of interest rates on the horizon, the stock market was becoming agitated because of the vibrancy of the US economy as evidenced by recent declines in the unemployment rate. Although it is becoming more obvious that the US economy is not in need of zero interest rates, which were installed as an emergency to bail the US out of the 2008-09 recession, the Federal Reserve's message assured investors that the commencement of rising interest rates was still likely to be 3 to 6 months away.

The assurance came even though the Federal Reserve has made significant downward revisions to its forecasts for unemployment. The Fed now sees unemployment falling from 5.8 percent currently to 5.25 percent by the end of 2015 and to 5.1 percent in 2016. These forecasts are below the 5.35% rate considered to be full employment.

Ordinarily, such a forecast would be reason enough to begin normalizing monetary policy. However, the outlook for inflation has cooled thanks largely to the drop in the price of oil. Ms. Yellen was confident that the drop in oil will be a net positive for growth since America is a net oil importer. In addition, Russia's trade and financial linkages to America were minimal. Experience, she noted, suggests the impact on inflation will be transitory.

Here is how the dictionary defines "transitory" when it is used as an adjective: *not permanent. "transitory periods of medieval greatness". Synonyms: transient, temporary, brief, short, short-lived, short-term, impermanent, ephemeral, momentary, fleeting, passing, here today and gone tomorrow.*

Yes, indeed. The drop in oil prices is transitory; prices can only drop so long and so far. Then after the price ceases falling, the dampening impact on inflation will be gone.

As we noted in our December e-mail update, OPEC is talking to US shale producers when it says that it's not logical nor fair to ask OPEC to reduce their production and not ask the other producers to stop their expected growth in supply.

OPEC is letting oil prices fall in order to curtail US shale production.

Experts say that the cost of shale oil production averages close to \$65 per barrel. In mid-November, Edward Morse, head of commodities research at Citigroup Global Markets, presented a chart of the cost of production in the primary US shale areas. The lowest costs are in the Marcellus Wet shale at \$35 per barrel of oil. However, the most significant production lies in more 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. Before the recent price decline, these areas were projected to account for approximately half of US oil production. Now, however, as the price of oil languishes in the vicinity of these costs, US production is bound to diminish.

Based on the fact that oil prices have dropped so fast and so precipitously, and are now close to shale production costs, it is likely safe to say that the price of oil should stabilize in the vicinity of current prices.

## Our Model Portfolio for 2015

Once the cost of energy stabilizes at a lower level, the benefit to consumers and their disposable incomes will be a tremendous economic boost. The Fed believes that lower oil prices will have the same impact as a tax cut, which will stimulate economies around the world. The sharply lower cost of energy is a powerful force that will lead to improving economies around the globe in 2015, and especially in the US.

With this context in mind, here is a break-down of our portfolio by its various sectors:

### Oil and Natural Gas

The sharp decline in energy-related stocks has brought our holdings to very attractive levels. As energy prices stabilize, investors will begin to regain their confidence and venture back into this sector to find excellent values. Our selections are bound to be among them.

### Real Estate

Our real estate related stocks have been stellar performers and have balanced out our portfolio nicely. We took a large profit in Commonwealth Equity (EQC-CWH) in 2014. In addition to relatively high dividend yields, we have very nice gains in our current real estate-related holdings: 70% on [Associated Estates Realty Corp \(AEC\)](#), 30% on [Hersha Hospitality \(HT\)](#), 71% on [Retail Opportunities Investment Corp \(ROIC\)](#), and 18.6% on the [Third Avenue Real Estate Value Investor Fund \(TVRVX\)](#).

It has been a reminder that it is always wise to diversify. Of course, low interest rates and a healthy US economy have been beneficial to this sector. Rising interest rates are a negative force on real estate, but an expanding US economy is positive on rental rates which more than compensates. Since interest expenses absorb only a portion of rental income, cash flow is enhanced. In addition, the value of real estate is leveraged to the net rental income it produces. Accordingly, both cash flow and values increase when economic activity and inflation heat up, even at the expense of higher interest rates.

### The “No-Brainers”

Just as the Fed’s assurance that it will not raise interest rates soon has been positive for the stock market, the jubilation will fade when the time arrives for the beginning of interest rates to rise to normal levels. It is also important to keep in mind that markets anticipate the foreseeable future. That means the market reaction is likely to come unexpectedly early.

We have hung on to our “No-Brainer” ETFs for this reason. As we explain in the following pages, these reverse ETFs will profit from rising interest rates and bond yields, and act as a hedge against the negative force that rising interest rates usually have on the market as a whole.

### Health Care

This was a strong sector for the portfolio in 2014. We cashed in on a 162 percent profit in 2014 on AMN Healthcare (AHS). We also have large gains in current holdings: 103% on [Pfizer \(PFE\)](#), 132% on [Stryker \(SYK\)](#), 40% on [Boston Scientific \(BSX\)](#), and 86% on [Hambrecht & Quist Life Sciences Fund \(HQL\)](#) which is now [Tekla Life Sciences](#).

The demographic forces caused by the graying of America and the rest of the industrialized world makes this sector rather insulated from economic conditions. Medical needs rise exponentially as people age. Our goal is to find companies creating value through innovation and patented treatments. As populations expand in emerging countries and become more affluent, growth potential becomes enormous.

### Cyclical

We have several positions that are clearly cyclical which means they benefit strongly from an expanding business cycle. These include [Ford \(F\)](#), [Freeport-McMoRan Copper & Gold \(FCX\)](#), [NCR Corp \(NCR\)](#), [Third Avenue Small-Cap Value Investor Fund \(TVSVX\)](#), [USAA Precious Metals & Minerals Fund \(USAGX\)](#), and [Xerox \(XRX\)](#). With the

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exception of XRX, we do not yet have gains in this group but expect to in 2015.

### Special Situations

The balance of our portfolio can be characterized as companies in specialized industries that are not particularly cyclical but that have strong growth aspects. These include **Agrium (AGU)** on which we have a 594% profit, **Symantec (SYMC)** where we have a 62 percent profit, and **Tetra Tech (TTEK)** with a 76% profit.

### Individual Updates

Here are updates on each position in our model portfolio in alphabetical order:

**Agrium (AGU)** was up 6.3 percent in 2014, extending our profit to 594 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.

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 is 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)** was up 50 percent in 2014, extending our gain to 70 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 most recent third quarter financials reported by the company, we value AEC at \$28.50 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 looking to make a profit. CEO and founder, Jonathan Litt, announced he 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. The stock has been moving up since the day of the announcement.

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.

**Boston Scientific (BSX)** was up 10 percent in 2014, extending our profit to 40 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.

In December, BSX announced favorable results for its Precision Spectra Spinal Cord Stimulator (SCS) System, which is implanted into the spinal cord, for offering long-term relief for patients suffering from lower back pain.

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.

**Chesapeake Energy (CHK)** fell in December, close to the price of our original recommendation of \$16.74 in mid-2012. It has since recovered but was still down 27 percent in 2014, trimming our gain to 22 percent. 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. Yet, we have another buying opportunity.

The market is forgetting that CHK is the second largest producer of natural gas, and that 70 percent of production volume comes from natural gas. Fracking for oil also produces natural gas as a by-product. A reduction in fracking for oil 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. This benefit should help CHK weather the volatility in the oil markets.

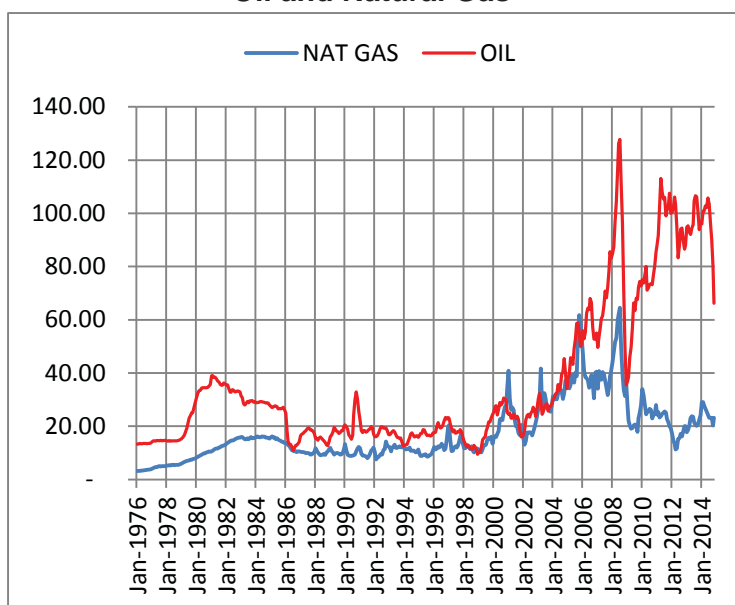
In late December, Chesapeake finalized the \$5 billion sale of some of its assets outside of its core positions in the Marcellus and Utica shale. The company subsequently announced that it will use part of the proceeds to buy back one billion dollars of CHK.

**Fidelity Select Natural Gas Fund (FSNGX)** also retreated in December, close to the price of our original recommendation of \$30.11. It recovered somewhat but was still down 13 percent in 2014, trimming our gain to 13.5 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. However, with a market price for natural gas at close at \$3.20 for one million BTUs, 5.8 million BTUs will cost \$18.56 (5.8x\$3.20). So the same amount of energy is still available for 34 cents on the dollar, if it is in the form of natural gas rather than oil. This difference still translates into an expanding natural gas industry, which makes this fund continue to be attractive.

The chart below shows the historic relationship between the costs of these two forms of energy.

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



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.

**Ford (F)** was added to our portfolio in November after a 20 percent dip in the stock price made it timely. It has since risen 8 percent. Morningstar's current fair value estimate is \$23 per share, considerably above its current price.

The dip brought the stock price close to 10 times 2014 earnings which are depressed because the new F-150 debut cost Ford about 13 weeks of production down time. Also dragging 2014 earnings was the preparation for 23 other vehicles that are either new or significantly refreshed. Ford's capital spending was close to \$7.5 billion in 2014 which was \$900 million more than in 2013.

Growth prospects in 2015 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.

Ford is also making significant cuts by reducing the number of platforms it uses to produce 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.

**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.

However, FCX is still primarily a copper stock. We include FCX in our portfolio because 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. 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.

Slow economic growth outside the US in 2014 put a damper on copper demand. 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.

**Hersha Hospitality (HT)** was up 30 percent in 2014 which is close to our gain so far. 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. In addition, 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.

HT saw the beginning of the benefits during the third quarter of 2014. We currently value HT's net asset value (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.

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)** has also suffered, but not as much as the drop in the price of oil. It declined 5 percent in 2014, trimming our gain to 4.1 percent.

In the past, this fund has achieved growth even during periods of declining energy prices. 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.

In December, ICENX paid a large long-term capital gain distribution of \$3.56 per share, a short-term capital gain distribution of 13.82 cents per share, and a dividend distribution of 8.89 cents per share, for a total distribution of \$3.8153 per share.

**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 -- 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 which caused the stock to slide to its current attractive level, at a steep discount to the market and its peers. 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.

NCR is down slightly since we included it in our portfolio in August of 2014. It remains a solid value.

**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. However, as low energy costs and low interest rates spur economies around the world, interest rates are bound to begin rising to more normal levels in 2015. It is only a question of exactly when and how fast.

The best forecast we have to go on is still that of the Federal Reserve itself. Along with its announcement of "patience" regarding normalizing interest rates, the Federal Reserve's trimmed its official forecast slightly, projecting that the benchmark Federal Funds rate will increase from zero currently to 1.125 percent instead of 1.2 percent by the end of 2015. Yellen did not change the expectation of an initial increase to be in June. The 2.5 percent forecast for the end of 2016 was left unchanged. 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 2.75 percent today to 3.875 percent by the end of 2015, and to 5.25 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 June, in accordance with the Federal Reserve's expectation, 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 4.7 percent, because it uses the most leverage. TBT would erode 2.3 percent, and TBF would erode 0.7 percent. Then, this erosion would be followed by steady price increases in all three ETFs, along with rising interest rates.

TMV would rise to \$54 by the end of 2015, and to \$103 by the end of 2016 which is close to three times its current price. The chart to the right shows the pattern, including the erosion until January.

TBT would rise to \$67 by the end of 2015, and to \$103 by the end of 2016, which is more than twice its current price. The chart to the right shows the pattern.

TBF would rise to \$30 by the end of 2015, and to \$38 by the end of 2016, which is 49 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.

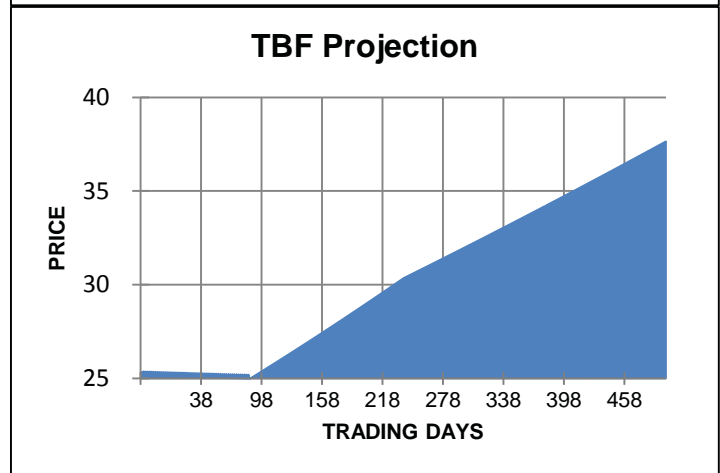
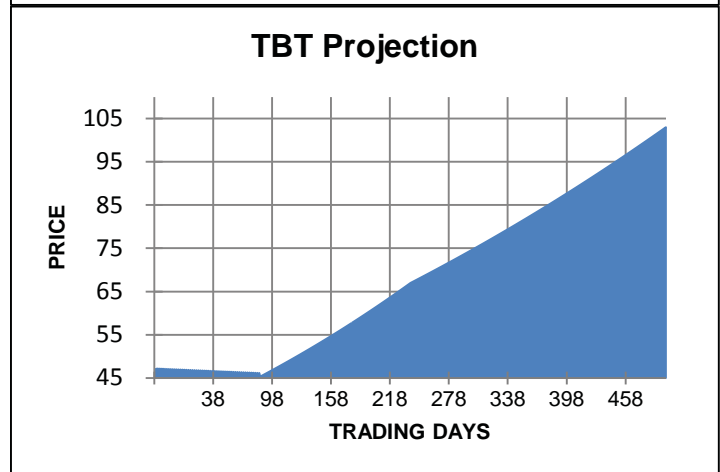
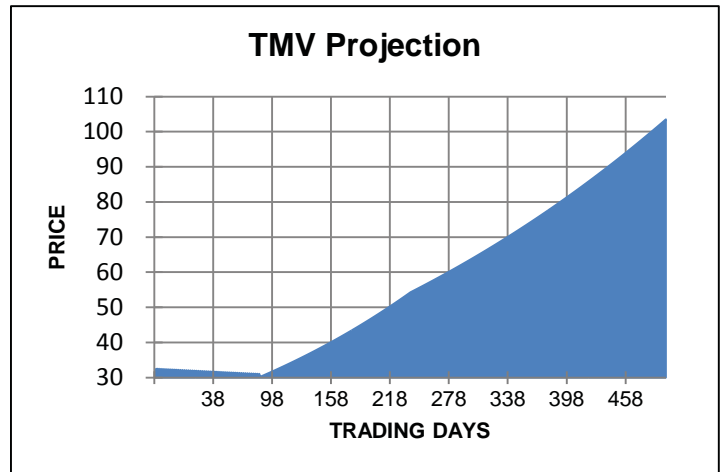
We all know that financial markets seldom move gradually, or in an orderly fashion. It is highly unlikely that bond yields will rise in a gradual and orderly fashion, in accordance with the Federal Reserve's gentle forecast. It is a safer bet to assume that the first whiff of rising interest rates will 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)** was up 5 percent in 2014, extending our profit to 103 percent. We added PFE to the portfolio when it became dirt cheap as the expiration date approached on its blockbuster drug, *Lipitor*. However, we saw a brighter future 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).

In December, PFE announced statistically significant favorable results for controlled tests on *Lyrica* which is on track to be a block-buster, bringing in \$5 billion annually.

PFE repurchased close to \$5 billion of its own common stock during 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)** was up 18 percent in 2014, extending our profit to 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.

Operating income nearly doubled in the third quarter above one year ago. 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)** was up 27 percent in 2014, extending our profit to 132 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.

In December, SYK announced a 13 percent increase in its dividend due to its cash flow and strong balance sheet.

Stryker's ability to acquire attractive companies gives it multiple avenues for continued diversified growth. 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 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.

**Symantec (SYMC)** was up 11.4 percent in 2014, extending our profit to 58 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. Ninety-nine percent of Fortune 500 companies are Symantec customers. By the end of 2015, 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)** was up 31 percent in 2014, extending our profit to 86 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. The biotech sector is projected to exceed the earnings of nearly all other sectors of the economy. However, 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)** was down 4 percent in 2014, trimming our profit to 75 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 recently restructured 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 opened 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.

**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.

The **Third Avenue Real Estate Value Investor Fund (TVRVX)** was up 17.3 percent in 2014, increasing our gain to 18.6 percent. This is 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.

In December, TVRVX paid a long-term capital gain distribution of 62.63 cents per share and a dividend distribution of 43.97 cents per share, for a total distribution of \$1.066 per share.

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.

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)** 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. In fact, the price decline has been so fast that it was suddenly too late to sell it. We believe it is worth keeping at this point, and waiting for a brighter day.

As we reported in our December e-mail update, at a recent energy conference, Transocean's CEO Steven Newman stressed the fact that the company's current contract backlog stands at a very robust \$23.6 billion which is expected to provide RIG with \$6.2 billion in revenue in 2015, and with solid revenue visibility for several years into the future.

In response to the worry that some of RIG's customers might not be able to withstand the plunge in oil prices and could be forced to cancel their contracts, Newman said:

*"So, I'll give you one statistic. At the height of the financial crisis in the latter part of 2008, the company had \$40 billion in contracted backlog and we lost 1% of that, \$400 million. And it wasn't because customers walked away from the contracts or forced us into renegotiating those contracts. It was because the customers ceased to exist. They simply evaporated as a result of their financial condition."*

Newman also pointed out that a majority of the company's platforms are leased by large integrated oil companies or national oil companies, and that these customers have very little likelihood of backing out of their contracts or going under. He also added that even the independent oil customers tend

to be large, well-capitalized companies, and can withstand the downturn in oil prices. Bottom line, the company doesn't lease its rigs to oil speculators so that provides a lot of security that its customers can endure the current turmoil in the oil markets.

Despite Newman's optimism, 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. Based on the most recent quarter, RIG can afford to pay the dividend. In December, RIG paid its dividend of 75 cents per share, unchanged from the previous quarter. The stability added by its backlog may allow the dividend to be affordable for the foreseeable future. However, 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. While the near-term is uncertain, on a longer term basis, RIG is in the vicinity of a buying opportunity as the premier provider of drilling platforms to the world's major oil companies.

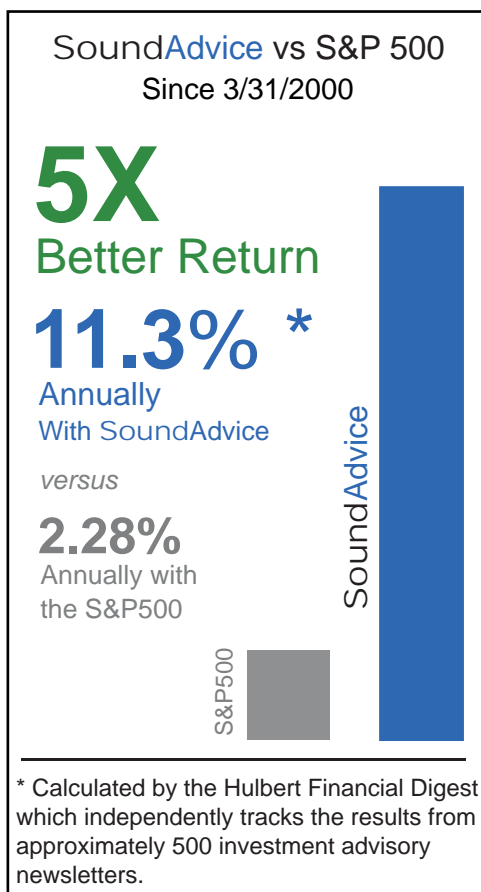
**USAA Precious Metals & Minerals Fund (USAGX)** was down 10 percent in 2014, extending our loss to 23 percent. However, we are hanging on to this fund because the increase in the money supply through the various quantitative easing (QE) programs in recent years will be sloshing through the economy, putting upward pressure on the prices of commodities and precious metals.

Geopolitical tensions are a positive for precious metals because they are safe haven assets. This fund will also benefit from inflation when the economy begins to overheat.

**Xerox (XRX)** was up 16 percent in 2014, 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 introduced 23 products in 2014 to attract customers and partners who need to outsource document processing and manage their printing services.

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



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 23.21	3.27%	\$ 25.00	BUY
Hersha Hospitality Trust	HT	NYSE	\$ 7.03	3.41%	\$ 7.86	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.79	3.57%	\$ 18.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 31.32	1.40%	\$ 34.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	\$ 94.72	2.80%	\$ 105.00	BUY
Ford Motor Company	F	NYSE	\$ 15.50	3.23%	\$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 23.36	5.35%	\$ 27.00	BUY
NCR Corp	NCR	NYSE	\$ 29.14	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 31.15	3.34%	\$ 33.00	BUY
Stryker Corp.	SYK	NYSE	\$ 94.33	1.12%	\$ 97.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 26.70	1.05%	\$ 28.00	BUY
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 22.87	0.00%	\$ 32.00	BUY
Xerox	XRX	NYSE	\$ 13.86	1.80%	\$ 14.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 19.57	1.79%	\$ 26.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 32.37	1.02%	\$ 34.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 14.19	0.63%	\$ 20.00	BUY
Transocean	RIG	NYSE	\$ 18.33	13.91%	\$ 25.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$ 11.80	0.17%	\$ 15.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 13.25	0.00%	\$ 14.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 31.73	0.00%	\$ 55.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 25.15	0.00%	\$ 30.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 46.39	0.00%	\$ 65.00	BUY
Symantec	SYMC	NASDAQ	\$ 25.66	2.34%	\$ 27.00	BUY
Teklka Life Sciences Fund	HQL	NYSE	\$ 24.88	0.00%	\$ 29.00	BUY

**Notes to the table:**

Prices are as of 12/31/2014. 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.

**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 \$1.54million in houses.

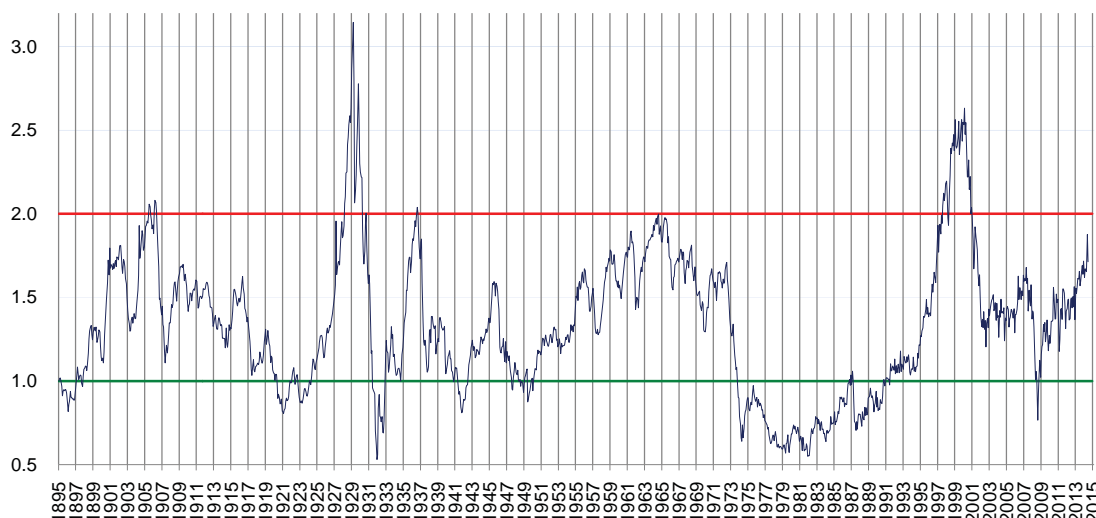
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$486 million, or 39.7 times more money—the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

### 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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