Gray Cardiff's

# SOUND ADVICE

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**The story as to what happened at Société Générale, one of France's most prestigious banks, at first sounded like a reenactment of Disney's *Sorcerer's Apprentice*, in which a wizard's lowly servant gets his hands on his master's book of magic, and marshals buckets and mops to do his chores. The results, a flooded castle and an angry wizard, pale next to the Soc Gen trader's loss of $7.2 billion.**

**Another strand of the story is emerging. In the Disney version, when the wizard intervenes, he brings things right with speed. When SocGen's senior executives finally acted, they made things worse, much worse, not just for their bank, but, it seems, for global markets. When management realized that a low level trader not only had amassed a $1.4 billion loss but also left the bank exposed to $70 billion more at risk, it decided to get out fast rather than get out smart.**

**The bank more than quintupled the trader's losses. Had the bank not dumped its positions into an already falling market, its losses and their impact on its own assets and on European, Asian and American markets certainly would have been less. In fact, the abrupt decision by the Fed to cut rates on the next day by 75 basis points in part was forced by the global market chaos SocGen magnified in its own panic. If its board of directors doesn't fire its senior executives for allowing the trader fiasco in the first place, it should fire them for how they responded to the situation.**

*--Gray Emerson Cardiff*

# The Agony of Early

This month's recommendation of a REIT fund extends last month's foray (**Icon Financial Fund**) into what were investment pariahs: financials and real estate. Since that recommendation, first it looked like our timing was good. But since then, ICFSX has been dragged back down with other financials. The bane of value investors always is being too early. However, compared to some, even the best of the best, we have bided our time.

Writing back in September about how the train wreck in the real estate debt market would present opportunities, we suspected: "Someone out there already has begun to gather those assets from frantic holders who …sell at prices dictated by an anxious market." We suggested these opportunistic investors would include Marty Whitman and Warren Buffett. The latter has made some buys in the insurance sector and now says he wants to set up a monoline bond insurance company that could do a better job than companies like MBIA, Ambac and Radian, all of which are teetering on the edge thanks to their careless involvement in subprime bonds. For Buffett to set out to build a new company is for him somewhat unusual, but with Berkshire Hathaway's gilt-edged credit rating, he already owns the essential foundation for a dominant bond insurance enterprise.

As for Whitman, there is no better example of a superb value investor, whose funds have appeared repeatedly in our portfolio and rewarded us without fail. If you want a quick introduction to how Third Avenue works, Curtis Jensen, Whitman's second in command, was interviewed recently on *Morningstar*'s website (http://www.morningstar.com/cover/videocenter.html?bctid=1390821992). However, right now Whitman has invested his way into the most volatile, and at present, the most painful part of the financial forest: monoline insurers, the very companies whose business Buffett wants to grab.

Marty Whitman, however, has been true to form. He buys other people's problems for pennies and the dolar, and decided a panicky market was

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misjudging the monoline insurers. Whitman as recently as last December praised management at monoline insurers he favored, and believed they would not need cash infusions.

In September, Whitman told his shareholders they now owned substantial positions in two monoline insurers, MBIA and Radian, bought starting in the latter part of July when "there developed a stockmarket panic as it relates to businesses involved with residential sub prime mortgages, home building, real estate development, and pending Leveraged Buy Outs ("LBO's"). The Fund bought heavily into this chaotic situation by acquiring the common stocks of very strongly financed companies where the common stocks were selling at meaningful discounts from our estimates of NAVs." In short, they were cheap enough to provide what seemed sufficient insulation in a detiorating environment. At least at the time they were cheap according to Marty's calculations. It turns out Whitman's buys were, to put it mildly, premature. The bad news was only beginning to flow, and his expectation that these insurers would not need cash infusions turned out to be wrong. Cash infusions meant dilution of ownership for existing shareholders like Third Avenue.

Indeed, the Third Avenue portfolio even before the monoline insurers started to fall apart already held positions in several such companies. Though the number of shares held in ACA and Ambac, two of the most precarious insurers, remains unchanged since the start of 2007, Third Avenue's commitments to MBIA and Radian respectively by late fall had doubled (7.1 million shares) and quintupled (10.4 million shares). At this point, Third Avenue owns 6% of MBIA and 13% of Radian.

Increasing a losing bet can make sense. Let me share one informal tool we use when scanning for investment ideas: we like to review SEC filings by managers we admire, and look for positions in the red to which he or she is adding shares. Then we dig into the numbers.

Whitman's year-end letter to shareholders (http://www.thirdavenuefunds.com/taf/documents/shareholderletters/aboutus-letters-07Q4.pdf), composed sometime in late December, reiterated the perspective seen in the September letter: "recent panic in the credit markets" has created buying opportunities in several areas but particularly in financial stocks themselves, which are selling "at ultra depressed prices because the companies are directly involved with the residential mortgage meltdown and/or the residential housing collapse." The Third Avenue Fund at that point had about 9% of its assets in these sectors.

Is Whitman always right? Hardly. When he gets it wrong in a big way, he is ready publicly to term the investment "pretty stupid," and given his shop's experience with distressed securities, feels Third Avenue "should have known better"when it gets something radically wrong, since "it is not like we lack experience in restructuring proceedings."

But even when a value investor is right about a company's value and durability, the risk is being wrong in the short-term. For the sake of Whitman and us shareholders, let's hope he eventually is right about these monoline insurers. Though Whitman was buying toward the end of 2007, the most tumultuous period for monoline insurers was just developing. Since then, events have stripped away any estimated margin of safety. It's hard to see how he can do any better than salvage some of his losses. Nonetheless, despite the pummeling the Third Avenue portfolio has taken from its monoline investments, its shares this year are about even with the overall market (which also has taken a beating), which testifies to Whitman's success with other positions born from the same discipline that led his fund into tough times with monoline insurers.

### *FINANCIALS*

For us the more significant question concerns not whether Third Avenue's adventures in bond insurers pans out but whether this shrewd fund manager's willingness to get involved signals that the financials and real estate sectors are now worth the risk?

Third Avenue has held positions for years in companies now being harmed by the housing/mortgage collapse: financial institutions, a home builder, and a building supplier. In fact, Third Avenue funds have owned for years companies that are nothing more than vast hunks

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# Yield Now, Capital Gains Later

Last month, we made our first dip into financials since the sector went to hell as investors discovered that the rocket scientists who created derivatives based on portfolios of subprime loans were just as gullible and just as greedy as the borrowers and lenders who generated those loans in the first place. The **Icon Financial Fund** got off to a nice start, but has been dragged back as the market continues to shudder over how banks and other holders of these mortgage derivatives and those who insured them are going to find a semblance of stability. There is a reason we put the fund into the Aggressive Growth portion of our portfolio.

At the risk of recruiting only masochists as subscribers, we are returning to a theme related to the January recommendation, another sector that has been decimated by the end of real estate euphoria, Real Estate Investment Trusts. Earlier in this decade as much as 25% of our portfolio was in real estate. Now we're down to just a single traditional REIT.

We bailed out as share prices exceeded the valuations we calculated for our REITs' assets. Though we expect to add individual REITs in the future, we'll start with a fund (diversification seems a worthwhile tactic at this bloody juncture) that is attractive not only because real estate now is a non-no but also because we can buy these assets and their fat yield (11.5%) not just at depressed prices but at a 5.2% discount from those depressed prices. Ah, the beauty of closed-end funds. Finally, reading this fund's SEC filings, suggests the managers have a touch of contrarian in them.

### *CLOSED END FUNDS*

We probably should start with a brief outline of closed-end funds (CEFs), a threatened species of security that trades like a stock but provides the diversification of a mutual fund. Exchange Traded Funds (ETFs) have multiplied furiously over the last few years, and are wrongly considered superior to CEFs. Unlike mutual funds, both ETFs and CEFs trade on exchanges and both can be shorted. However, ETFs differ fundamentally from CEFs, which are managed by real, live men and women. ETFs by contrast are mechanically rebalanced to reflect a pre-existing index.

Accordingly, ETFs trade at their Net Asset Value (NAV) as do traditional mutual funds. Any deviation from the current market value of an ETF's portfolio is quickly arbitraged away. By contrast, for CEFs discrepancies are the norm. Some CEFs trade at a premium to their NAV, while others—the majority in fact—trade at a discount to that value. Occasionally these discounts reach double-digits.

Why persistent discounts exist for most CEFs is debated among academics and traders but no explanation yet has explained the size of these deviations. We are satisfied to focus on these discrepancies as a function of the market's mood. When investors are optimistic about the market and, in the case of REIT CEFs when they were absolutely giddy about REITs, CEFs traded above the NAV of their assets. When investors are pessimistic, like now, REIT CEFs trade at a discount. Indeed, among the 18 REIT CEFs we track, two-thirds change hands at less than their NAV.

Most REIT CEFs use leverage, that is they borrow funds short-term to increase the size and thus the yield of their portfolio. The bet simply is that the spread between borrowing costs and yield justifies the increase in risk. As REITs plummeted over the last 12 months, the downside of leverage becomes clear: owning more shares to generate more income exposes the fund to greater losses: the added dividends in a down market do not compensate for the increased losses in share price.

### *REITS*

REITs and REIT funds peaked about 12 months ago, as the hottest commercial real estate prices had surged beyond reasonable levels. Owners, who had been buyers when cash flow from their existing and new properties was robust, became sellers as capitalization rates (the ratio of cash flow divided by price) plummeted in a greedy market. Even when deals did not make sense to real estate veterans, private equity

investors continued to bid up prices, especially for office buildings in major metropolitan areas. Private buyers presumed they could run these properties, despite their lack of experience managing properties, more efficiently than did the professional real estate managers from whom they snapped up properties. As often is the case, the end of the boom was marked by the biggest deal of all, the sale for $39 billion by Sam Zell and other shareholders of Equity Office Properties, to Blackstone Partners, whose huge IPO a few months later signaled the end of another bubble, this time for private equity investing.

REIT prices' retreat coincided with the effects of rising interest rates finally hitting home. Despite repeated Federal Reserve increases in short-term rates, relatively cheap borrowing costs persisted at the start of 2007, and encouraged private equity groups to buy real estate (and other assets). As with small-fry residential real estate geniuses who used cheap mortgages to buy and flip condos in places like Miami and Las Vegas, so too for private equity shops. Their brilliance turned out to have had more to do with cheap borrowing costs than with brain power. Big deals for commercial real estate in the months following the Equity Office REIT sale vanished. Once the distortion in market prices created by private equity ebbed, the bottom fell out of the REIT market. The Vanguard REIT Index, for example, on February 9, 2007,the day the Blackstone deal was completed, closed at $28.45. Today it closed at $19.62, a 31% decline. <u>We are finally getting back to realistic prices for REITs, and we think it is time to look around</u>. If nothing else, we like the yields these funds offer.

## *DWS RREEF FUND II*

**DWS RREEF Real Estate Fund II (SRO—AMEX)** is a $501.9 million closed-end fund with a diversified domestic real estate portfolio. Its distributions over the past 12 months represent a 11.5% yield (we are excluding the year-end capital gains distribution, since such events cannot be predicted. For that matter, the fund managers warn that even the regular quarterly distributions cannot be guaranteed.). Were we to include the year-end distribution, the fund's cash flow to shareholders works out to a 13.3% yield.

SRO as does almost every REIT CEF uses leverage to achieve that yield. The fund's leverage ratio is at its indicated maximum of 33%.. The fund's expenses come in at 1.83%, a bit higher than we would like, but, we think, balanced by a distribution that has increased twice since the fund debuted in August 2003.

The DWS REIT funds (there's another closed-end fund, SRQ, as well as a cluster of open-ended funds) are managed by a quartet of experienced real estate investors. More importantly, these funds are part of the deep real estate division of Deutsche Bank that oversees not only passive investments in real estate securities ($14.5 billion) but also actively owns and manages $69 billion in properties. We cannot overestimate the value of the real-time intelligence about markets and values that such hands-on familiarity gives RREEF. As the fund notes in its 2007 report to shareholders: "The information advantage RREEF obtains from this vast direct-side portfolio helps RREEF to anticipate the trends within the various sectors of the real estate market and to evaluate how these trends will likely affect the REIT universe." One other thing: the fund's charter permits is investment not just in REITs but directly in real estate. SRO's association with the larger Deutsche Bank real estate division suggests that under the right circumstances—a depressed real estate market, for example—it could profit from not just passive but active investments. At present, there is no direct investment in real estate.

**The DWS RREEF Real Estate Fund II trades at a discount from its NAV, brings a double-digit yield, has a track record of raising its distributions,provides diversification, presents a value-oriented portfolio, and is run by managers in close touch with not just REITs but also with the real-time real estate market.**

The fund's access to real-time operating and market conditions over the entire U.S. might explain how the managers are positioning the fund after a year of grim returns for REITs. The portfolio spreads over all REIT sectors. At the end of September, the fund was concentrated most heavily in hotels (17%), regional malls (21.7%), Office (24.1%), Apartments (14.5%), Healthcare (13.5%) and Industrial (13.1%). Com-

### Dodge & Cox Stock Fund Reopens

**The Dodge & Cox Stock Fund (DODGX), which we owned until it closed in early 2004 to new investors, reopened on February 4th. For our money DODGX is the best big-cap value fund when you consider not only its superior performance, but also its investment philosophy, its discipline, its low management fees and, its insistence on putting its shareholders' interests first. How long the fund will remain open depends on how much and how fast new money flows in.**

**The minimum initial investment is $2500 in standard accounts and $1000 in IRAs. Subsequent investments must be $100 or greater. Why did we sell it out of our portfolio? Our rule is that whenever a fund closes to new investors, we cannot continue to hold it, because our own new subscribers cannot buy it. At the time we sold, we advised subscribers fortunate enough to own it, to put it away for keeps. It is an heirloom position.**

**The fund closed because it could not effectively invest the cash tsunami from new investors in 2003 and early 2004 who saw how strongly the fund was performing. Now, as the market cools, we suspect these same investors are getting cold feet. The "Buy-high, Sell-low" sort that don't temperamentally fit Dodge & Cox's approach to investing, we suspect, are heading for the exit. Dodge & Cox now needs fresh cash to maintain its existing positions until they reach their potential as well as in a weak market to "capitalize on attractive opportunities." We expect to devote the March issue to this fund provided it stays open. Though we preach that subscribers should know the nuts and bolts of any investment before putting money into it, we would understand if you just do it without waiting for a full recommendation to avoid the possibility of missing this opportunity.**

pared to the portfolio three months later, we see a significant jump for Hotels (17%) and an even larger drop in Office (down 14%), Regional Malls (down to17%),Apartments (down from 12%) and Healthcare (down to 8%).

Trying to tease from these shifts an impression of how the fund managers think is tricky, but we believe they suggest a value-oriented, perhaps even a contrarian, approach. For example, against a background of a slowing U.S. economy the fund's increase in exposure to hotels represents a contrarian bet on the sector most vulnerable to a slowdown. Unlike other real estate classes, hotels are not buffered by leases, and when business and leisure travelers decide to stay home, hotel rooms go begging. Among various REIT subclasses, hotel REITs have been the weakest performers over the last 12 months. Indeed, given our own zig-when-the-market-zags approach, when sifting through REIT CEFs, we gave serious consideration to one that included "lodging" in its name. In fact, SRO has slightly more exposure to hotels than does the supposedly dedicated fund (RHR).

On the other hand, the fund has reduced its exposure to apartments, which had been favored by REIT investors on the theory that the end of real estate euphoria along with the higher borrowing costs to buy your own home would increase demand and raise rents for apartments. As for the most obvious defensive sector that REIT investors had not beaten up badly, healthcare, the fund's drop in exposure three month's later is extraordinary. Cuts in retail and industrial are more consistent with a slowing economy.

It's also possible that the fund is expanding its holdings in financial REITs, both those with properties occupied by financial services companies and also those involved in lending—the darkest part of the REIT forest, but, to our thinking, one that is too cheap to ignore after so much pain. Our hunch is based on the big jump in assets lumped in its 12/31/07 fact sheet under the category "Other," which in ealier reports that listed specific holdings was heavy with a REIT that splits its assets between mortgage debt and lower-quality corporate lending.

SRO during the REIT retreat has fallen a bit futher than the REIT universe, a result not only of its fat distributions but also because of its leverage. Provided we are close to a bottom, the leverage loss would become a plus in any recovery.

### *DISCOUNTS DON'T GUARANTEE PROFITS*

Common wisdom says that you should buy closed-end funds only at a discount. This is sound advice, and one reason we are making this recommendation. However, it is no guarantee that you are insulated against losing money even if the discount shrinks. Deep discounts from NAV, though they provide a snapshot of

the relationship between what a share costs and the current share prices in the underlying portfolio, does not guarantee that the market price of the fund will rise as the discount shrinks. There are two ways that the discount can shrink: either, as we hope, the market pushes the fund shares higher without a parallel increase in the NAV or the NAV declines faster than does the share price. For example, SRO when it hit its all-time high back in February sported a discount from NAV hovering around 14, but today, after the price has shrunk by a third, the discount has fallen to less than 6%. Remember, when you buy a closed-end fund, you own its NAV, which can rise or fall. The discount just tells you how the market feels about those assets' potential.

***SUMMARY***

REITs have gotten beaten down over the past year right along with the financials. In fact, they have suffered even more than financials. If you go back a year to REITs' last hurrah and look at the Morgan Stanley REIT Index compared to the SPDR Financials ETF, REITs have had an even worse time. The fears that have taken REITs down, we believe, are excessive when you compare the two sectors. REITs continue to have high occupancy, continue to collect their rents and don't have to wonder how real their balance sheets are, while financial companies in contrast are still trying to find firm footing. Though we believe financials are either at or near a bottom, for income investors—and those who want capital gains but don't mind collecting a nice yield—REITs are far more comfortable to own. The DWS RREEF Real Estate Fund II trades at a discount from its NAV, brings a double-digit yield, has a track record of raising its distributions, provides diversification, presents a value-oriented portfolio, and is run by managers in close touch with not just REITs but also with the real-time real estate market. We recommend buying SRO up to $15. ***SA***

*(Cover Story, continued)*

of the landscape in places like California and Florida. Whitman, like any good value investor, going in tells his shareholders the potential negatives for these positions and observes that no one, including his own fund, "is able to pick a bottom for securities prices, or a near bottom" due to challenging market conditions. In the current case with financials, no one can know "how deep the crisis will become, or how long it will last. " His best guess for financials is two to four years.

Even when discussing these investments' "good side," you cringe at some of his assumptions. For example, Whitman calmly anticipates that there will be "a dramatic deterioration in book value" from current backward-looking levels, that upcoming quarterly results will reveal "staggering" losses, that some companies might require significant cash infusions to remain solvent, that someothers might even have to liquidate, that rating agencies will begin to apply "soft qualitative data" such as investor perceptions rather than use strictly the sorts of hard, quantitative data relied upon by Third Avenue. Most of all, Whitman realizes that "the crisis will become increasingly deep and prolonged."

Why did Whitman venture into such dangerously depressed territory? Beyond staking out common shares in companies he believes are selling at deep discounts, all Whitman has to go by is experience. The mortgage meltdown, he notes, is nothing new for the U.S. economy. Over his lifetime on Wall Street, he has seen "virtually every sector of the American economy [go] through depressions as bad as anything that occurred in the 1930s: energy, banks real estate, savings & loans, Wall Street brokerages, row crops, steel, automobiles, machine tools...[T]he odds favor overcoming the current crisis in residential housing and residential housing finance without underlying damage to the U.S. economy."

That we can enter the arena after Whitman, gives us some comfort. Our entry point never can be perfect, yet is closer than Third Avenue's to the end of the financial and real estate freefall. We can only hope that waiting for the turn exacts less pain than it has for Third Avenue. As for REITs, the subject for this month's recommendation, there are far fewer unknowns, far less likelihood of the sorts of hidden catastrophes that bludgeoned investors in monoline insurers who unfortunately got caught out in worse than anticipated weather. ***SA***

# Portfolio Updates

Since we closed the portfolio for the January issue on January 11th, first the market dropped on recession fears, got happy after the Fed provided a double dose of rate cuts and Washington promised a fiscal stimulus, and ultimately faltered after Wall Street became convinced that recession was coming.Over that period, the Dow is down 3.4%, the S&P 500 5% and the Nasdaq 5.4%. The *Sound Advice* portfolio fell as well, down 3.1%. With earnings season continuing, each report that missed or exceeded expectations amplified or countered the general market anxiety. Extraordinarily sharp moves up and down characterized the last month's activity.

**Icon Financials Fund** looked good at the end of January—it was up about 3%— but a recurrence of anxiety about bond insurers when combined with economic anxieties knocked it lower again. ICFSX ended down 5.5%. The proposition remains the same: there is little confidence in financials as investors presume what they see now they will see forever. We're taking the hardly wild-eyed optimist's view that the economy will right itself and financials will heal.

Our two positions tied to the financial markets, **American International**, the global insurance company and **HRPT Properties Trust**, the office/industrial REIT, had different months. AIG dropped 12%, which until the market opened on 2/11 made little sense. Now we know that AIG, though it was clear in revealing how much exposure it had to the mortgage mess, might have been too optimistic in how it valued that exposure. Hence, after we closed the book for this issue, AIG after saying an auditor questioned certain valuations, took another double-digit hit. We don't yet have enough information to determine the real damage, but our instinct in such situations is that AIG is being overly punished and current prices make for an opportunistic entry point. For HRP, and REITs overall, the month was fine. HRP added 10% after factoring in the quarterly dividend. For the backdrop to REITs' potential, see page 3 for a REIT closed-end fund we like.

Energy and natural resources, which have been an anchor for the portfolio, had a rough month after recession concerns brought into question the durability of demand for oil and natural gas as well as all metals and other commodities. Crude fell as low as $87 a barrel, though on Friday it rallied back up to $91.77. Though we understand that speculators respond to every penny move in oil and other commodities, we are more interested in how the companies we own will profit from prevailing prices, and frankly, even with oil in the low $80s, energy companies would do fine. Apparently in the short run the market thinks otherwise. If concern about a slowdown or recession persists or even if a recession ensues, we would use that as an opportunity to increase exposure. We are not ready to endorse the peak-oil theory that asserts the world's supply of oil is in permanent decline, but we do believe that future barrels will become progressively more difficult to extract, both for political and geological reasons, and that prices will continue their upward direction. For oil companies themselves, this represents a real challenge. For energy service companies this is pure opportunity. **Royal Dutch** dropped 16% and **Icon Energy Fund** 11.5%. **Transocean**, which dominates the ultradeepater drilling business, and is a prime beneficiary in the quest for new fields, which lately have almost been all beneath the seas and at ever-increasing depths, lost 8.2%. The only energy position to avoid red ink this month was **EnCana**, primarily a natural gas company, which benefited from cold snaps around the U.S. and Canada. It rose a whopping 0.2%.

**American Century Global Gold Fund** fell 6.9% as gold fluctuated around the $900 an ounce level, ending at $922. Our thesis remains that a weak dollar now and the prospect of inflation in the future should keep gold and other precious metals in demand, though the journey into four-figure prices is not going to be smooth.We still favor miners, as represented by this fund, over bullion itself. **Anglo-American** had a particularly back-and-forth month as it was hurt by concerns over a slowing global economy and then by news that mines in South Africa, which are at the core of its businesses, were limiting or

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# Sound Advice Portfolio for February 2008

| Income With Growth | Symbol | Exchange/ Phone | Price/ N.A.V.* | Yield** | Buy Limit | ACTION |
|---|---|---|---|---|---|---|
| **DWS RREEF Real Estate Fund II** | **SRO** | **AMEX** | **$13.24** | **13.32%** | **$15.00** | **BUY** |
| HRPT Properties | HRP | NYSE | $8.03 | 10.46% | $10.00 | BUY |
| **Diversified Growth** | | | | | . | |
| Agrium | AGU | NYSE/TSE | $61.43 | 0.18% | $75.00 | BUY |
| American International | AIG | NYSE | $50.68 | 1.58% | **$55.00** | BUY |
| Boston Scientific | BSX | NYSE | $12.33 | 0.00% | $16.00 | BUY |
| Coca-Cola Enterprises | CCE | NYSE | $23.28 | 1.03% | $28.00 | BUY |
| Disney | DIS | NYSE | $30.32 | 1.02% | $37.00 | BUY |
| Dodge & Cox Intl.Fund | DODFX | 800-621-3979 | $40.29 | 6.85% | N/A | BUY |
| Excelsior Value & Restructuring | UMBIX | 800-345-6611 | $53.03 | 1.57% | N/A | BUY |
| Fastenal | FAST | NASDAQ | $40.89 | 1.12% | **$45.00** | BUY |
| Fidelity Japan Fund | FJPNX | 800-544-8888 | $12.70 | 0.31% | N/A | BUY |
| Gabelli Global Telecom | GABTX | 800-422-3554 | $23.38 | 0.99% | N/A | BUY |
| Honeywell | HON | NYSE | $57.83 | 1.73% | $64.00 | BUY |
| Insituform Technologies | INSU | NASDAQ | $13.08 | 0.00% | $16.00 | BUY |
| Johnson & Johnson | JNJ | NYSE | $62.03 | 2.68% | $73.00 | BUY |
| Liberty Capital | LCAPA | NASDAQ | $109.04 | 0.00% | $130.00 | BUY |
| Mattel | MAT | NYSE | $20.64 | 3.63% | **$25.00** | BUY |
| Microsoft | MSFT | NASDAQ | $28.56 | 1.54% | $36.00 | BUY |
| Molson Coors Brewing | TAP | NYSE | $45.12 | 1.82% | $59.00 | BUY |
| Odyssey Healthcare | ODSY | NASDAQ | $8.80 | 0.00% | $11.00 | BUY |
| Sara Lee | SLE | NYSE | $13.65 | 3.08% | **$17.00** | BUY |
| Schering-Plough | SGP | NYSE | $19.77 | 1.11% | **$26.00** | BUY |
| Sony | SNE | NYSE | $42.99 | 0.51% | **$55.00** | BUY |
| Sprint Nextel | S | NYSE | $9.44 | 1.06% | **$14.00** | BUY |
| Superior Industries | SUP | NYSE | $18.25 | 3.51% | **$20.00** | BUY |
| Tetra Tech | TTEK | NASDAQ | $18.10 | 0.00% | $26.00 | BUY |
| Third Avenue Value Fund | TAVFX | 800-443-1021 | $55.07 | 3.80% | N/A | BUY |
| United Parcel | UPS | NYSE | $70.58 | 2.38% | $76.00 | BUY |
| Wal-Mart Stores | WMT | NYSE | $48.76 | 1.37% | $55.00 | BUY |
| Whole Foods Markets | WFMI | NASDAQ | $39.38 | 1.83% | $45.00 | BUY |
| WisdomTree Dividend Top 100 Fd | DTN | NYSE | $53.63 | 3.16% | N/A | BUY |
| Xerox | XRX | NYSE | $15.33 | 1.04% | $19.00 | BUY |
| **Energy/Natural Resources** | | | | | | |
| American Cent. Gold Fund | BGEIX | 800-826-8323 | $23.73 | 0.47% | N/A | BUY |
| Anglo-American PLC | AAUK | NASDAQ | $29.04 | 3.89% | $36.00 | BUY |
| EnCana | ECA | NYSE/TSE | $67.31 | 1.19% | $75.00 | BUY |
| Icon Energy Fund | ICENX | 800-764-0442 | $28.48 | 34.35% | N/A | BUY |
| Plum Creek Timber | PCL | NYSE | $40.81 | 4.12% | $50.00 | BUY |
| Royal Dutch Petroleum | RDS.A | NYSE | $67.53 | 4.26% | $87.00 | BUY |
| Transocean | RIG | NYSE | $125.18 | 24.45%*** | $150.00 | BUY |
| **Aggressive Growth** | | | | | | |
| Comcast | CMCSA | NASDAQ | $17.06 | 0.00% | $22.00 | BUY |
| Discovery Holdings | DISCA | Nasdaq | $22.08 | 0.00% | $33.00 | BUY |
| Electronic Data Systems | EDS | NYSE | $17.16 | 1.17% | $24.00 | BUY |
| Ford Motor Convertible Pfrd. | F.PRS | NYSE | $32.40 | 10.03% | $41.00 | BUY |
| Getty Images | GYI | GYI | $26.62 | 0.00% | **$28.00** | BUY |
| Icon Financial Fund | ICFSX | 800-764-0442 | $11.06 | 15.09% | N/A | BUY |
| Liberty Global | LBTYA | NASDAQ | $37.41 | 0.00% | $45.00 | BUY |
| Maxim Integrated | MXIM.PK | NASDAQ | $18.37 | 1.89% | **$23.00** | BUY |
| The Prudent Bear Fund | BEARX | 800-711-1848 | $6.62 | 3.02% | N/A | BUY |
| Symantec | SYMC | NASDAQ | $17.90 | 0.00% | $20.00 | BUY |
| Time Warner | TWX | NYSE | $16.01 | 1.37% | $20.00 | BUY |
| Western Digital | WDC | NYSE | $28.20 | 0.00% | **$33.00** | BUY |

***Prices as of the market close on Friday, February 8, 2008**

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

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

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

ceasing operations due to a country-wide shortage of electricity generation from the country's over-stressed and aging power infrastructure. However, growing investor interest in coal companies sparked support for AAUK, which derives 10% of its operating profits from coal and is striving to increase that portion with projects in China. For the month, AAUK is up 3.8%. The unfriendly attempt by BHP Billiton, the world's largest mining company, to acquire Rio Tinto, and the fascinating move by Alcoa and Chinalco, the Chinese aluminum company, to buy 12% of Rio Tinto as a strategic block to BHP Billiton's ambitions, underlines a quickening trend toward consolidation.

As for earning season, it has had its heroes and its casualties. **Mattel**, which collected bad news, bad press and income-statement hits from recurrent recalls of toys produced in China surprised the world with very strong results thanks to international sales (domestic sales slid 3%) and announced it was bumping up its share buyback program by another $500 million. MAT has been retiring shares for the last few years to the tune of $2 billion (104 millon shares), shrinking the pieces of the pie by 20%. MAT ended the month up 20.4%.

Other positive earnings boosted names such as **Fastenal**, which depends on construction and industrial companies for its revenues and thus came under suspicion as the economy slows, rose when its quarter turned out well saw shares jump 17.9%. **Western Digital** has done much better than the technology sector in general over the last month, buoyed by non-computer customers' demand for memory. Earnings more than doubled over the previous year's quarter, and management is optimistic about future demand and profit margins. Valuations, despite rising sales, remain modest. Since the last letter, WDC is up 17.6%, a quick bounce from last month's bottom.

**Symantec**, which has been struggling to realize value from its acquisition of Veritas, announced stronger results for the third quarter. Guidance for the fourth quarter also came in higher than expected. However, Symantec has a history of beating estimates, so what is different this time? Symantec now owns Vontu, which specializes in large scale data security (versus Symantec's historical emphasis on PC security), and nicely complements the far bigger acquisition of Veritas, which specializes in large scale data management software. If (and this is the biggest if) Symantec can weld these two together and leverage its own reputation with PC security, maybe it can begin to realize value from the too expensive Veritas acquisition. Since the January letter, SYMC is up 17.2%.

Not everything worked in technology. The big news that **Microsoft** wants to buy Yahoo! for $44 billion created more worry than hope. Effectively Microsoft is offering a premium that barely brings Yahoo! back to where its shares stood last autumn as it began to tumble to its pre-offer low.

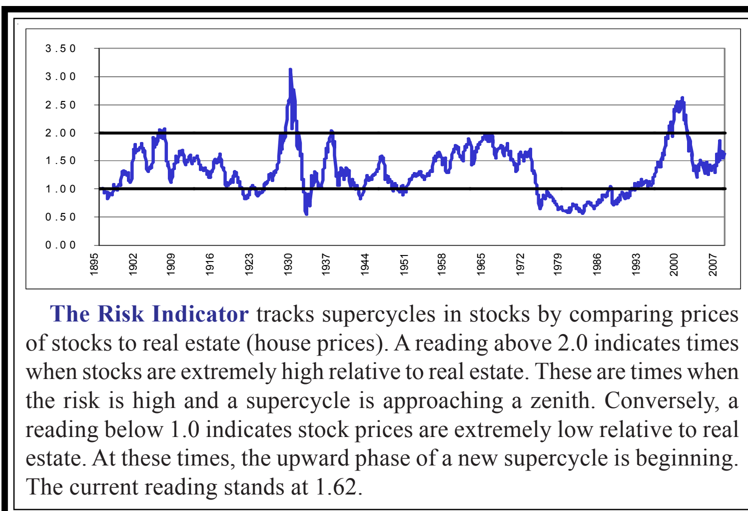
There will be immense noise about whether Yahoo! is what Microsoft needs to battle Google and establish itself as a pillar of the Internet. The present MSN site has many strong parts but is far behind both Google and Yahoo! in making money from the Internet. On the news, MSFT dropped 6.6%, and continued to fall, closing down since the last letter by 15.8%. Yahoo! is resisting Microsoft, and if the deal does happen, it will happen at a higher price. We'd be a buyer while shares are depressed by the news, since we fall into the camp that believes Yahoo! was undervalued and needed new leadership.But are the guys in Redmond up to the task?

**Maxim Integrated**, the chip maker, got hit with poorer results for the quarter, and said it would be closing a plant and taking charges. Burdened by its still unfiled past years' SEC quarterly and annual reports that still are under revision and its consequent delisting from Nasdaq, MXIM remains a wounded name that we think will recover not only its Nasdaq listing but also investor favor once the chip business regains its footing. For the month, MXIM lost 21%.

Another name under siege is **Schering-Plough**, which peaked last year before saying that sales growth for Vytorin, its combination of a statin with Zetia, another cholesterol reducer, had slowed. Since then, the company announced results from a test to determine how Vytorin/ Zetia affects plaque build up. The results were disappointing, showing a slightly better outcome from statins alone. Investors fled, knocking shares down this month by 28.7%, a drop that is built on the assumption that Vytorin/Zetia sales will cease. Even if this preliminary result stands, Vytorin/Zetia remains the default alternative for lowering cholesterol if a patient cannot tolerate statins and/or statins alone are not reducing cholesterol to desirable levels. Furthermore, SGP and Merck, its partner in developing and marketing the drug, are running a vastly more definitive study of its efficacy, the results of which might resassure physicians. Finally, Schering-Plough has come a long way from when we bought it in the low teens. Today, Fred Hassan, the CEO, has added numerous new products and tightened up what had been a dysfunctional company. We're enthusiastic buyers.

Finally, **Boston Scientific**, which like SGP had been beaten down amid overhyped negative clinical studies that only now are being reversed, added 5% as investors have started nibbling. Earnings will be announced after we close the issue, but we think that BSX has a bright future after a devastating few years.***SA***

# Sound Advice Market Indicators for February 2008




**The Risk Indicator** tracks supercycles in stocks by comparing prices of stocks to real estate (house prices). A reading above 2.0 indicates times when stocks are extremely high relative to real estate. These are times when the risk is high and a supercycle is approaching a zenith. Conversely, a reading below 1.0 indicates stock prices are extremely low relative to real estate. At these times, the upward phase of a new supercycle is beginning. The current reading stands at 1.62.

**The Diffusion Index of Lagging Indicators** gives "Sell" signals when all of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading. This reveals a strengthening economy and inflationary pressures ahead. Currently 67 percent of the indicators is above its level of six months earlier.

**The Diffusion Index of Leading Indicators** gives "Buy" signals when its individual leading economic indicators drop below their respective levels of six months earlier, providing a zero percent reading. This reveals a softening economy and a ripe atmosphere for a lasting decline in interest rates. The latest reading came in December 2005 as a "Buy". Currently 75 percent of the indicators are above their level of six months earlier.

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. Between each "Buy" signal and each "Sell" signal, the S&P 500 rose substantially without exception. The average gain was 31.1 percent, not counting dividends. On an annualized bases the gain was 16.8 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

| Buy Signals Date | S&P 500 | Sell Signals Date | S&P 500 |
|---|---|---|---|
| | | Feb-69 | 101.50 |
| Sep-69 | 94.51 | May-73 | 107.20 |
| Nov-74 | 71.74 | Aug-77 | 97.75 |
| Jan-81 | 132.97 | Dec-83 | 164.36 |
| Sep-85 | 184.06 | Oct-87 | 280.16 |
| Mar-89 | 280.00 | Sep-89 | 347.33 |
| Oct-92 | 415.10 | Jan-95 | 464.72 |
| Feb-97 | 798.38 | Sep-99 | 1,383.60 |
| Feb-03 | 841.15 | Jul-05 | 1,234.18 |
| Dec-05 | 1,248.29 | | |

During the intervening periods between "Sell" signals and "Buy" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased a paltry 0.8 percent per year, a return that could have easily been beaten many times over with safe investments such as Treasuries, short-term bonds or other low-risk investments.

To assess whether a market crash is likely after a "Sell" signal, we turn to the Risk Indicator. If the Risk Indicator is close to or above 2.0, we know the market is relatively high and contains a high degree of risk. This was indeed the case in September 1999 when the Diffusion Index of Lagging Indicators flashed a "Sell" signal and the Risk Indicator was (substantially) above 2.0. The peak came in six months, marking the end of the bull market as well as the peak of Supercycle Five. The market subsequently crashed. The S&P 500 dropped 39 percent until the next "Buy" Signal was given by the Diffusion Index of Leading Indicators in February 2003 (which was the exact month that bear market low point was reached). During that decline, most stocks suffered greater losses. The NASDAQ dropped nearly 80%.

Conversely, the market does not suffer lasting declines after "Sell" signals when the risk level is low. For example, the "Buy Signal" in November 1974 was one month from the bottom of that bear market, and came at a time when the Risk Indicator was below 1.0. Consequently, this "Buy" signal also marked the beginning of Supercycle Five. As the upward phase of Supercycle Five ensued and the Risk Indicator remained relatively low, the market did not experience lasting downturns after "Sell" signals. Instead, the bull run was merely interrupted with short declines, sideways movements, and sometimes even advances. Even the three-day decline in October of 1987, which became known as the "Crash of 87", was followed by a stampede of buyers snapping up bargains. I remember seeing individual investors lined up to invest outside discount brokerage offices because the phones were logjammed with buyers.

However, as previously noted, when Supercycle Five reached its peak and the Risk Indicator climbed above 2.0, the decline was severe after the September 1999 "Sell" signal due to the excessive heights to which prices had previously been propelled.

We use the ***Sound Advice*** Market Indicators to influence our approach and nature of our recommendations. When "sell" signals are in force, our recommendations are more defensive in nature. We will be looking for special situations and are likely to recommend taking profits more readily. Conversely, during "buy" signals, our recommendations will be more aggressive. We believe that these proprietary indicators have been important factors in our ability to consistently outperform the market averages (more than double the profits from the S&P 500 since 1/1/2000). ***SA***

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