

# SOUND ADVICE

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Though we are reluctant to find significance in what the market is doing on any single day, how stocks responded Monday to news that Fannie Mae and Freddie Mac were now in conservatorship prompted us to pull the copy intended for this space. Even if the announcement was expected, it was still stunning. Immediate drops of 85% to 90% for the common and preferred were the norm. The preferred at best is a long-odds lottery ticket.

For the financials, it was a bonanza: homebuilders, most mortgage lenders, banks, insurers boomed. Yoked sectors such as consumer discretionary also burst higher. How much of this was short covering remains to be seen.

However, what caught our attention amid the Fannie/Freddie headlines was talk that expectations are rising that the airlines and the auto industry, the two weakest crucial parts of the U.S., are now more likely to get federal help. Despite the talking heads lecturing us that the brutal bailout of the GSEs creates no moral hazard, i.e. the tendency to take greater risks when we believe there is some sort of safety net, we think it does just that.

We own Ford's cumulative preferred because we think Ford on its own can survive. We don't like the conclusion Wall Street is drawing from the GSE experience, especially because it was precisely the expectation that the GSEs had a "special relationship" with Washington that allowed investors to sleep easily when they should have been pacing the floor.

--Gray Emerson Cardiff

## Credit Glut to Credit Crunch

Alan Greenspan completed his 19-year tenure as chairman of the Federal Reserve perplexed. Starting in late spring 2004, he repeatedly worked to drive interest rates higher to tamp down excesses the Fed's remarkably easy-money policies had created, yet intermediate and long-term rates refused to cooperate. "What's going on?" he complained to a lieutenant. For example, just before the Fed began raising short-term rates that stood at 1% in June 2004, the 10-year Note yielded 4.73% and a 30-year fixed-rate mortgage was priced at 6.29%. By the time Ben Bernanke took over the Fed in February 2006, 20 months and 14 Fed Funds rate increases later, that short-term measure had reached 4.25%. But the 10-year Treasury Note yielded 5.1% and that 30-year mortgage carried a 6.76% rate. Yes, the 10-Year (and other rates) had risen but hardly reflected what the Fed expected. The Fed had roared, and produced merely a mouse.

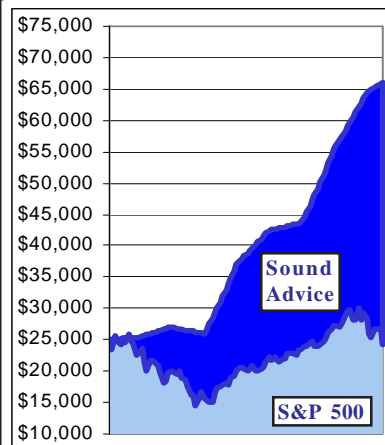
Bernanke would move rates to 5.25%. This is what perplexed Greenspan (and Bernanke), what the Maestro, as Greenspan was hailed, had termed "The Conundrum," a tag that drew less attention than "irrational exuberance," but which ultimately when compared to the mischief irrational exuberance wreaked on the stock prices had an even more devastating impact on the markets and the real economy. Indeed, that contradiction between rising short-term and falling or sluggish long-term rates revealed forces that lead to today's credit crunch.

In February 2005 remarks to the Senate Committee on Banking, Housing and Urban Affairs, Greenspan vented his confusion: After naming but discounting economic forces such as fall of the Soviet Union, the rise of new economies in India and China, acceleration in global saving and

### Sound Advice Annual Returns

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- 15.2% Since 1-1-06
- 17.1% Since 1-1-03
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**\$24,489 with the S&P 500,**  
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# Credit Glut to Credit Crunch

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productive capacity, dwindling concerns about inflation, Greenspan, shrugged. "But none of this is new and hence it is difficult to attribute the long-term interest rate declines of the last nine months to glacially increasing globalization. For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum [SA emphasis]. Bond price movements may be a short-term aberration, but it will be some time before we are able to better judge the forces underlying recent experience."

Only now are we beginning to understand what perturbed Greenspan and others. Indeed, the refusal of long-term interest rates to respond to the stimulus of higher short-term rates reflected the cresting tide of a global credit glut that prompted investors to push their cash into less and less prudent places, all the time in search of relatively higher yield.

Greenspan had begun his report to the committee with yet another of his paeans to the resiliency of the American consumer, which he traced to the housing market. Even if Americans were not saving much (1% versus the historical average of 7% established over the previous 30 years), household wealth was up, noted the Chairman, thanks mostly to the rise in housing prices, and the ability of homeowners to pull cash out of their houses through refinancing kept them spending kept the economy humming..

The global housing market was the prime beneficiary of the credit glut. Those persistently low relative long-term rates kept fixed-rate mortgages at real historical lows in relation to short-term and even 10-year Treasuries. Greenspan claimed this reflected the confidence of lenders, who were willing to put their money out to borrowers at remarkably low rates that required very small spreads over what money cost them. In retrospect, rather than "confidence," perhaps "desperation" or recklessness better explained their motive for such borrower-friendly terms: lenders, particularly foreign lenders, were hungry for yields higher than they could find at home. Hence, they flooded the credit markets drowned interest rates and frustrated the Fed.

Fast forward to now. We have just the opposite. We have a credit crunch, in which lenders, regardless of how stimulative central bank rate policies might be, refuse to lend. Spreads between the 10-Year Treasury Note and a 30-year mortgage from January 2003 until October 2007 had remained below 200 basis points (=2%), but since then have moved to 242 basis points even as the Fed has taken the Fed Funds rate from 2% to 5.25% and the 10-Year has remained under 4%.

A recent survey of senior lending officers reveals not only tightened lending standards and terms on all categories of loans to consumers and to all sizes of businesses, but also that demand for loans had also dwindled. About 80% of those responding said that they had raised the spread or gross profit margin above their cost of funds.

The fear among lenders is palpable, and not surprising given the devastation the mortgage meltdown has caused on lenders' balance sheets. It is now irrelevant whether overconfidence or desperation drove lenders to put money into the hands of people and companies which had anyone cared to look at their creditworthiness would not have qualified. We now are paying for that stupidity.

What will bring an end to such tight credit conditions? Not interest rates. The key will be stabilization in the housing market that would give lenders some confidence to lend, and borrowers some reason to borrow. We'll know that moment has arrived when foreclosure rates stabilize and start to subside. That time is not yet. Last month, for instance, foreclosure rates compared to the same period in 2007 were up a stunning 55%. Vulture buyers are getting busy, but there is far too much road kill for them to digest quickly.

In a weak equities market, our attitude is to be a buyer of savaged companies, which means we continue to buy selected financials, understanding that we cannot pick the bottom, and that by the time the foreclosure rate does slow, the market already will have jumped. We appreciate this can be painful, but, if experience is a guide, it also can be profitable, highly profitable.SA

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### If You Think Oil Is Crucial, Think Water

This month we are introducing a fund that provides diversification in a sector already in our portfolio, and, we believe, has considerable potential for future profits: water. We already own **Tetra Tech** and **Insituform**, which in Tetra Tech's case means primarily environmental remediation of tainted water and desalination and in Insituform's case means revitalizing underground sewage and potable water pipes. In fact, the fund we have settled on **PowerShares Water Resources Fund (PHO—NYSE)**, an Exchange Traded Fund (ETF), owns both companies. Tetra Tech is its largest position (4.7%). In our own portfolio, TTEK has been a big winner: up 27% so far this year, and 151% since our May 2005 recommendation. INSU (3.2% of PHO) this year is up 20% but remains 11% below our entry price in May 2007.

PHO goes into our Natural Resources subportfolio if for no other reason than potable water even more than oil is the most crucial natural resource, but is priced as if it has no worth. At our home, we pay about a third of a penny per gallon for drinking water that primarily flows into reservoirs from Sierra Nevada snow melt. As with oil, there is a finite supply. Unlike oil, for which we can and must develop renewable and complementary substitutes, there is no substitute for water.

The amount of water we have today essentially is what we had when the earth was formed, and of that about 1% is potable. Making the best use of that 1% is among the 21<sup>st</sup> century's greatest challenges. For informed investors how water resources are managed and maximized offers rich opportunities not so much in owning water utilities themselves but in every other segment of the chain that connects water to us.

Let me make a little detour to make a point. Consider the just completed 2008 Olympics in Beijing that cost at least \$40 billion to stage. Another \$17 billion was spent to improve the quality of Beijing's notoriously polluted air, which got a good deal of media coverage, since many were concerned it could degrade athletes' performances. Little if any attention was lavished on how China was dealing with an associated challenge, Beijing's compromised water supply, which is just as

dreadful as the air pollution, and the simple fact that though 20% of the world's people live in China, it possesses only 7% of the globe's potable water.

Back in 2006, Beijing announced it would invest \$1.6 billion to guarantee cleaner water and waste water disposal by the start of the 2008 Olympic games. The goal was to treat 90% of urban Beijing's and 50% of outlying villages' waste water. Also, more than 1000 sewer pipes that feed into local rivers would be capped.

But Beijing's water supply remained worrisome as the games approached. Not only were some reservoirs low or dry but also the fourth largest was shut, because it failed minimum potability standards. To make sure there would be enough water to float the Olympics, the central government rushed to divert water from farmland in the Baoding region (infuriating and impoverishing local farmers), about 90 miles from the capital. Some of the water transmission system used for this project already had been constructed as part of a vast water diversion program designed to siphon water from the Yangtze River in the south to Beijing and elsewhere in northern China where drought is a recurring threat and the bulk of the population resides. About half of China's population relies on water supplies that do not meet World Health Organization standards.

Before you decide that China's critical water problems are extraordinary or reveal the problems of an aggressively emerging economy, consider that at the other end of the development spectrum, here in California, the largest state economy in the U.S., we face aging infrastructure, constraints on conservation, the effects of climate change, and are in the middle of a record drought. There is a water crisis in California just as there is across the country. But a penny still buys three gallons of that sweet Sierra clear piped to my home by my local utility.

Of course, 40 years ago a gallon of gasoline cost me 29 cents. For that matter, less than a decade ago, a barrel of oil fetched less than \$10. Water resources, despite how crucial they are, demand better management and more rational economics. For more general concerns about water and waste removal

# Sound Advice on PowerShares Water Resources ETF

systems, check our comments when we initially recommended **Tetra Tech** and **Insituform** for more information.

## ***FINDING THE RIGHT FUND***

It's an easy case to make that water resources pose as much a challenge in the 21<sup>st</sup> century as does obsessively covered energy. TTEK and INSU are one solution. But how, if you are more comfortable with a diversified portfolio of water-related companies, how should you invest?

Until the advent of Exchanged Traded Funds, the answer was you couldn't. Today there are four ETFs based on water resource indexes, but it would be a serious mistake to think they are interchangeable. Our choice, PHO, concentrates on companies that trade on U.S. exchanges, a mix of domestic firms and ADRs. The other choices are PowerShares Global Water Resources Fund (PIO), PHO's global sibling, First Trust Water Index Fund (FIW) and the Claymore S&P Global Water Index ETF.

We prefer a domestically focused ETF, which means that PHO's international sibling and the Claymore fund fall out of consideration. As for the First Trust Water Index, it meets our domestic criterion, also has a proprietary index, but trades lightly, averaging over the last three months a scant 51,400 shares a day compared to PHO's daily volume of 660,000 shares. We prefer our investments when possible to be liquid.

PHO pioneered the water-resources index fund concept, first trading in December 2005, though the underlying index, the Palisades Water Index, came into being several years before this tradeable translation appeared.

The Palisades Water Index, which today includes 33 stocks traded in the US. 80% of the index must represent companies that derive 50% or more of their revenues from water and water-related businesses. The other 20% allows for companies that are involved in the industry but derive smaller portions of their revenues from it.

A small portfolio means that the successes and failures of any single member of the index have a significant impact on overall performance. Furthermore, because the majority of these companies are midcap to small (the median market cap is \$2.8 billion), volatility also increases, especially because the index keeper follows a modified equal weighting model. For example, TTEK has a 40% greater impact on performance than does General Electric, which comprises 3.3% of the index.

As we have discussed in earlier issues, indexes that weight their portfolios by market capitalization such as the S&P 500 (and CGW which is based on the S&P Global Water Index as well) tend to overlard

themselves with high price ratio positions, which for a value-oriented investor is anathema. The benefit of an equally weighted portfolio is that it must trim positions as they rise in price and adds to them when prices decline, a version of dollar cost averaging.

It's also important for investors to understand what "index fund"

means today. A generic definition on the SEC's website, giving as an example an S&P Index fund, says that "an ETF is similar to an [open-ended mutual] index fund in that it will primarily invest in the securities of companies that are included in a selected market index." The SEC, as do most investors, viewed index funds at their genesis as clones of the standard benchmark indexes that dropped or added companies rarely, usually due to mergers and acquisitions, bankruptcies or other extraordinary events, though, as we've observed, there is more than a little active management, especially in the Dow Jones Industrial Average. But we digress.

Index funds provide investors with returns that are no better or worse than the universe of stocks included in the index, which John Bogle, the Johnny Appleseed of index funds, considers the gold standard. He suggests it is impossible for a managed fund over a long period to outperform the total return of an index, since even if a talented manager can eke out a small advantage, that bonus vanishes after a managed fund's fees are subtracted.

**Potable water even more than oil is the most crucial natural resource, but is priced as if it has no worth. Unlike oil, for which we can and must develop renewable and complementary substitutes, there is no substitute for water.**

## Sound Advice on PowerShares Water Resources ETF

In the *Sound Advice* portfolio we own, with one exception, managed funds, which have outperformed benchmarks like the S&P 500 over their histories thanks to a value-oriented approach. These outcomes result from managers with value-oriented mindsets and the discipline to follow that strategy in good times and especially, as is the case now, in bad.

However, sometimes an index fund is not all that different from a managed fund, because the indexes themselves can be managed in terms of what they include and how the positions are weighted. PHO is a case in point, and that is something we like, provided the index keeper knows what he is doing.

For example, PHO originally included 38 stocks, five more than today, of which several were not in the original index. Some of the removed names were acquired, others were dropped due to redundancy, or because the firm failed to fulfill the anticipated expansion of its water resources component. It's reasonable given the flux among companies in the industry to expect more changes as the industry evolves and the index keeper's views of its future evolve along with it.

### **PHO**

According to the prospectus, the fund seeks to match at least 90% of the underlying index's performance. The index itself, originated and maintained by an investment group, Watertech Capital, is revised and rebalanced every three months, at which time the index's creator, Stephen Hoffmann, is authorized to alter the weightings to reflect his firm's views of where the subsectors and individual companies will tend.

For instance, in Watertech's July 15<sup>th</sup> newsletter, Hoffmann explained why the index had slashed its exposure to water utilities. "domestic utilities, . . . in our opinion, are entering a protracted period of low earnings generation, squeezed by regulatory and capital spending requirements on the one hand and anemic rate relief and conservation efforts on the other. This is the basis for the relative underweighting of the water utility sector within the index."

From 21% of the index in January 2007, water

### Palisades Water Resources Index Top Ten Positions (9/3/08)

Company	% of Index	Mkt Cap (billions)
Tetra Tech	4.70%	1.69
Urs Corp	4.11%	2.78
Calgon Carbon	4.02%	0.9
Danaher Corp	4.01%	26
Itron Inc	3.96%	3.46
Badger Meter	3.92%	0.68
Valmont Industries Inc.	3.90%	2.78
Aecom Technology Corp	3.82%	3.17
Veolia Environnement	3.81%	24.12
Agilent Technologies	3.63%	12.31

utilities currently represent 10%. The subsequent drop off in share prices for these companies over that period validate Hoffmann's insight. Hoffmann's willingness to reweight the index to diminish the impact of sectors he thinks are weak and to emphasize what he thinks strong is little different from what any active fund manager does. The only salient difference is that the Palisades Water Index must select from among a 33-stock universe, though as noted that too can change.

Indeed, Hoffmann expects to see a good deal of reconfiguration in the water resources industry, which he argues is not organized to meet the present to say nothing of future demands. Thus, he expects a realignment of existing companies as well as the entry of others with innovative technologies. Because Hoffmann has spent the past 25 years as a student, executive and consultant in the economics and science of water resource management, he brings an abundance of experience, knowledge and connections within the industry. Watertech, besides managing the index, also runs private portfolios and investments in water-related ventures, hence PHO shareholders enjoy an index maintained by someone intimately knowledgeable about its content.

So what does the Palisades Water Index include? As of the end of June, its six subsectors accounted for the following portions: Water Utilities (currently 10% of the index) supply homes and businesses with water, and include regulated and unregulated firms, Treatment companies (17%) either provide tools and processes

## Sound Advice on PowerShares Water Resources ETF

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to make water potable or make waste water disposable. Analytical/Monitoring firms (15%) provide the tools and processes to meet regulatory and industrial standards for water, Infrastructure/Distribution businesses (22%) provide the means, devices and processes required to transport potable and waste water, and Water Resource Management firms (25%) provide consulting, engineering and technical services in irrigation and water management systems. Finally, conglomerates or multi-businesses (12%) are large companies that have a significant involvement in any of the first five categories.

If Hoffmann sees Water Utilities as underperformers for the foreseeable future, he is positive about both Water Management and Treatment, since each addresses the most fundamental problem for water resources: how to maintain, protect and rehabilitate existing water sources and how to make safe the final products, whether they be potable water or waste water. He also considers Analytics/Monitoring, a fragmented business, as crucial not only to Management and Treatment but to any segment of the water chain.

### ***WATER RESOURCES PLUS (OR MINUS)***

If water the 21st century's most crucial commodity, PHO's focus on water will be rewarded. However, there is a flip side to the 50% criterion used to select index constituents. For many of these companies, especially the biggest, most sprawling conglomerates like GE, Siemens and Danaher, which in themselves account for 10% of the index, much of their revenues do not come from water resources businesses. Each of PHO's largest market-cap members has been aggressively acquiring water-related companies, and GE aspires to be seen as an infrastructure company, but when you own PHO you own a share in all of each company's various businesses. Owning PHO also means considerable exposure to companies that are more broadly defined as infrastructure and/or basic industrial manufacturers. Indeed, the purest water resource plays are the utilities, which PHO prudently pared down.

Look at the top-10 positions. We'll skip TTEK, since it's familiar to most subscribers. URS Corp is an engineering and design company that among other projects specializes in water supply planning, water

storage and transmission, water quality management planning, water treatment and distribution, and wastewater collection, treatment and disposal. Calgon is the biggest supplier of activated carbon, which is used in filtration of liquids and gases, and also designs and installs treatment systems using activated carbon and other processes. Danaher Corp. derives a smaller portion of its revenues from water resources from companies like Hache-Lange, which does water analytics and non-water specific businesses that sell into the industry, Itron sells hardware, primarily meters, software and services to the electric, gas and water utilities for data collection and monitoring, Badger Meters sells into markets similar to Itron, Valmont designs and manufactures mobile irrigation equipment, Aecom, spun off last year from Ashland, the oil and gas refiner, designs and engineers among other projects water and waste water systems, Veolia Environment, a French firm, works across the spectrum of water, waste and energy services, designing, building and managing facilities for each. Agilent Technologies designs analytical tools for bio-scientific and electronics companies, which are useful in the water resource sector.

In researching this recommendation, we ran into a common misconception that PHO, because it addresses a unique commodity for which demand is inelastic, is non-cyclical and does not correlate with the overall market. This in part results from PHO outperforming the S&P over its brief life.

However true that perception might be for the purest water companies, it is misleading for PHO itself, since investors in general, when buying and selling the underlying shares value them not primarily as water plays but as engineering or industrial companies. Consider how the portfolio performed last Thursday (9/4) when the S&P tanked 3%. PHO dropped even more in tandem with other cyclical components of the S&P.

We emphasize this not because we think the ETF is flawed by lack of purity. In fact, we like the inclusion of some-non water revenue, because it tempers (admittedly on the up and the down sides) how the portfolio performs. For subscribers interested in expanding what TTEK and INSU contribute to our portfolio or who prefer a shotgun to a rifle for targeting a sector, PHO is the solution. [\*\*SA\*\*](#)

## Portfolio Updates

Over the last month, the markets have been lethal, taking back the fat gains reported in the last letter. Since we closed that issue on August 8<sup>th</sup>, the S&P is off 4.2%, the Dow 4.4% and the Nasdaq 6.6% as the dueling themes of energy and commodities on one side and financials on the other were joined by overarching anxiety about a slowed U.S. and global economy. For the first half of 2008, energy, natural resources and other commodity-related stocks had been strong, financials and consumer discretionary stocks weak, while technology, as played by the Nasdaq, had done respectably. What has changed since mid-July is a sharp correction/collapse in energy, natural resource and commodity-related stocks, in part a response to wildly overenthusiastic price surges that culminated in \$147 per barrel oil, and in part a response to slowing demand, a natural market answer to \$4+ gasoline. As the dollar rallies, hard assets now are falling. As with energy, the weak dollar enhanced all hard assets denominated in dollars. Now that trend is in reverse, it is taking down what it had boosted. The Fed is telling us that the next move in interest rates will be higher, which attracts dollar buying, which means the dollar is finding more favor among short-term speculators. Finally, anxiety about a global economic slowdown turned another leg of the rationale for higher commodity prices wobbly. Our own portfolio on an unweighted basis did not escape, though the damage was less. We were off 3.9%.

Last month's issue focused on six of the 11 funds in our portfolio. The common theme for each is that exposure to financials has increased as that market sector tanked. **Third Avenue Value Fund** made the boldest foray, buying bond insurance companies like Ambac, Radian and especially MBIA, all of which had been decimated as investors worried they might become the ultimate bagholders should mortgage-

based bonds and derivatives default. Starting in late July no subsector within financials has rallied as strongly and consistently as these insurers. MBIA, for instance,

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closed on September 5<sup>th</sup> at \$16.61. On July 27<sup>th</sup> it had closed at \$4.27. Nonetheless, the market was so savage for equities in general that TAVFX still was flat since the August letter. If TAVFX could hit one out of the park and still not make money, it's no surprise that none of the other funds did better, though those that have moved most aggressively toward financials were dinged least. The **WisdomTree Dividend Top 100 Fund** slipped 0.2%, and the **Icon Financial Fund** 0.2% as well. The **Dodge & Cox Stock Fund** dropped 4.5%, and its international sibling, DODFX, lost 8%. The **DWS RREEF Real Estate Fund** lost 2.9%.

Individual financials were not so fortunate. **American International Group** tumbled another 10.2%, much of that after a Credit Suisse analyst speculated there were more, perhaps much more, undiscovered write-downs for AIG to take. At this point, we wonder whether anyone should consider our opinion on AIG worth the time to read, since we have been constructive about the long-term prospects all the way down. Nonetheless, the Credit Suisse story and the market's violent acceptance of it testify to just how unhinged Wall Street has become about financials in general and AIG in particular. Until the housing market stabilizes, at which point mortgage-related securities

# Sound Advice Portfolio for September 2008

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
DWS RREEF Real Estate Fund II	SRO	AMEX	\$11.70	15.08%	<b>\$13.00</b>	BUY
HRPT Properties	HRP	NYSE	\$7.46	11.26%	<b>\$9.00</b>	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$78.14	0.14%	<b>\$90.00</b>	BUY
Boston Scientific	BSX	NYSE	\$12.57	0.00%	\$16.00	BUY
Cintas	CTAS	NASDAQ	\$30.56	1.51%	\$35.00	BUY
Disney	DIS	NYSE	\$31.56	0.98%	\$37.00	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$36.80	7.50%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$110.08	16.27%	N/A	BUY
Fastenal	FAST	NASDAQ	\$50.85	0.90%	<b>\$54.00</b>	BUY
Fidelity Japan Fund	FJPNX	800-544-8888	\$11.17	0.36%	N/A	BUY
Gabelli Global Telecom	GABTX	800-422-3554	\$20.36	1.14%	N/A	BUY
Honeywell	HON	NYSE	\$47.72	2.10%	\$59.00	BUY
Insituform Technologies	INSU	NASDAQ	\$17.58	0.00%	\$21.00	BUY
Johnson & Johnson	JNJ	NYSE	\$70.67	2.35%	\$75.00	BUY
CarMax	KMX	NYSE	\$15.40	0.00%	\$18.00	BUY
Liberty Capital****	LCAPA	NASDAQ	\$15.64	0.00%	\$20.00	BUY
Mattel	MAT	NYSE	\$19.03	3.94%	\$25.00	BUY
Microsoft	MSFT	NASDAQ	\$25.65	1.72%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$48.33	1.70%	\$62.00	BUY
Odyssey Healthcare	ODSY	NASDAQ	\$9.69	0.00%	\$11.50	BUY
Sara Lee	SLE	NYSE	\$13.48	3.12%	\$19.00	BUY
Schering-Plough	SGP	NYSE	\$19.26	1.14%	\$28.00	BUY
Sony	SNE	NYSE	\$36.08	0.61%	\$50.00	BUY
Sprint Nextel	S	NYSE	\$7.99	1.25%	\$12.00	BUY
Superior Industries	SUP	NYSE	\$17.52	3.65%	\$24.00	BUY
Tetra Tech	TTEK	NASDAQ	\$26.75	0.00%	\$33.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$49.37	4.24%	N/A	BUY
United Parcel	UPS	NYSE	\$63.89	2.63%	\$70.00	BUY
UnitedHealth Group	UNH	NYSE	\$27.71	0.11%	\$40.00	BUY
Wal-Mart Stores	WMT	NYSE	\$60.74	1.10%	<b>\$65.00</b>	BUY
Whole Foods Markets	WFMI	NASDAQ	\$18.12	0.00%	\$25.00	BUY
WisdomTree Dividend Top 100 Fd	DTN	NYSE	\$47.33	4.32%	N/A	BUY
Xerox	XRX	NYSE	\$13.76	1.16%	\$19.00	BUY
<b>Energy/Natural Resources</b>						
Anglo-American PLC	AAUK	NASDAQ	\$21.35	5.29%	<b>\$30.00</b>	BUY
EnCana	ECA	NYSE/TSE	\$67.68	2.36%	<b>\$85.00</b>	BUY
Icon Energy Fund	ICENX	800-764-0442	\$29.34	33.35%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$48.52	3.46%	\$56.00	BUY
<b>PowerShares Water Resources ET</b>	<b>PHO</b>	<b>NYSE</b>	<b>\$20.37</b>	<b>0.34%</b>	<b>\$23.00</b>	<b>BUY</b>
Royal Dutch Petroleum	RDS.A	NYSE	\$62.57	4.60%	<b>\$73.00</b>	BUY
Transocean	RIG	NYSE	\$122.27	24.45%***	\$140.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$24.81	10.68%	N/A	BUY
<b>Aggressive Growth</b>						
American International	AIG	NYSE	\$22.34	3.58%	\$30.00	BUY
Comcast	CMCSA	NASDAQ	\$20.61	1.20%	\$24.00	BUY
Discovery Holdings	DISCA	Nasdaq	\$16.52	0.00%	\$29.00	BUY
Ford Motor Convertible Pfrd.	F.PRS	NYSE	\$23.51	13.82%	\$30.00	BUY
Icon Financial Fund	ICFSX	800-764-0442	\$8.79	18.99%	N/A	BUY
Liberty Entertainment****	LMDIA	NASDAQ	\$26.65	0.00%	\$29.00	BUY
Liberty Global	LBTYA	NASDAQ	\$33.67	0.00%	\$35.00	BUY
Maxim Integrated	MXIM.PK	NASDAQ	\$19.71	1.89%	\$26.00	BUY
The Prudent Bear Fund	BEARX	800-711-1848	\$6.49	3.08%	N/A	BUY
Symantec	SYMC	NASDAQ	\$21.48	0.00%	\$25.00	BUY
Time Warner	TWX	NYSE	\$15.25	1.44%	\$20.00	BUY
Western Digital	WDC	NYSE	\$25.77	0.00%	<b>\$35.00</b>	BUY

\*Prices as of the market close on Friday, September 5, 2008

\*\*Yield represents all distributions during previous 12 months divided by current share price.

Note that all fund distributions fluctuate annually.

\*\*\*Special Distribution

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

\*\*\*\*Recently spun off

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

## Sound Advice: Portfolio Updates for September 2008

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will also stabilize, holders of any debt, particularly debt related to mortgages, will continue to suffer. We presume that much, probably not all, of the accounting write-downs taken by AIG and other holders will flow back onto their balance sheets. If it is any consolation, AIG bounced back after the pummeling the CS analyst triggered. Is that a bottom for AIG? We're not prepared to declare anything close to that, though we are willing to continue buying this humbled giant.

There is a handful of successful positions this month starting with **Odyssey Healthcare**, which provides hospice care and services nationwide, added 6.1% after a good earnings report for the last quarter. Occupancy and revenues both rose. The pivotal issue here is whether Medicare will cut payments to hospice providers despite some support in Congress for less drastic treatment. Our view remains that hospice care, especially in the home, is an effective way to reduce Medicare and Medicaid costs to say nothing about the human benefits it affords.

**Wal-Mart** also reported good numbers, and continues to be viewed as the best retail investment, because consumers when they shop insist on paying the least for the most, and WMT excels in that. The shares added 5%. Another retail story, **CarMax**, improved 3.4% as investors decided used-car sales in a weak economy represented the most likely to succeed vehicle sales model.

**Mattel**, the toymaker that got a big boost from a civil suit that found MGA, a competitor, had used designs by a Mattel employee to create its highly successful Bratz dolls, got knocked back when the jury did not provide the expectedly huge damage number. The real question is whether MGA can retain ownership of the line, or have to hand it over to Mattel. That won't be decided soon, and in the meanwhile, appeals will delay any final judgment. On the disappointment, MAT fell 10%.

When we look at the energy, natural resources portfolio, there are degrees of performance. **Plum Creek Timber**, the land and lumber company, dropped back 2.6% from near-historical highs, and **Agrium**, the fertilizer manufacturer, ended 0.5% lower. **EnCana**, a Canadian energy company, even ended 2% higher as natural gas toward the end of the month slowed its decline. **Royal Dutch** declined 7.5% as both the impact of a rising dollar on both how oil is

priced and how Royal Dutch's share price moves when expressed in dollars added to the absolute fall in energy prices. **Transocean**, the ultradeepwater driller, dipped 3.9% despite rising day lease rates and a fattening inventory of business. The **Icon Energy Fund** dropped 5.2%.

Metals fared the worst. **Anglo American** fell 16.7% as both traders and investors fled the sector. The **USAA Precious Metals & Minerals Fund** at 10.7% followed gold and industrial metals lower. The stable of **Liberty Media** spinoffs and tracking stocks did produce positive performers since the last letter. **Liberty Global**, the international cable television network, added 6.1% and **Liberty Entertainment**, a tracking stock, was up 3.1% after the parent company said it would replace the tracking stock by spinning off the assets LMDIA is tracking plus a few other pieces of business. Tracking stocks derive their value from particular assets within a company, allowing investors to "own" a specific portion of a company's sales and profits. Once spun off, the synthetic relationship of Liberty Entertainment ceases, and the shares can be used by management for corporate expansion. Our original investment in Liberty Media has been profitable, but the ongoing spinoffs, tracking stocks and asset swaps make our head spin. Still, in a weak month, these two Liberty offspring did great.

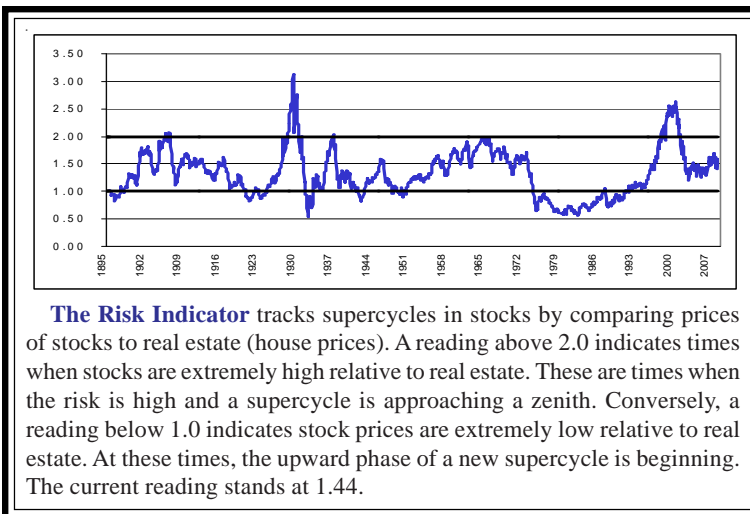
In a bleak market decline, relative performance even when negative can indicate stocks that might have superior future performance on the upside. Two manufacturing-related stocks are notable: **Cintas**, which provides uniforms, work clothes, washroom services and supplies as well as a cluster of other products and services provided by its route drivers, showed no loss, and **Fastenal**, a chain of retail hardware and work materials stores, even added 0.5%. Their relative buoyancy also can be explained by each's very good performance this year.

**Symantec**, which we highlighted last year as one of three busted-merger stories, has had a good year, up 33% while the S&P has lost 15.4%, this month lost 2.3%. Compare that to the Nasdaq's 6.6%. For that matter, on a weighted basis, our portfolio is down only 1.8% this year. Yes, we know that you can't bank or spend relative performance, but it does suggest better days, something we can all hope for. **SA**

# Sound Advice Market Indicators for September 2008

**The Diffusion Index of Lagging Indicators** gives “Caution” 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 25 percent of the indicators are above its level of six months earlier.

**The Diffusion Index of Leading Indicators** gives “Aggressive” 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 an "Aggressive". Currently 67 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. After each “Aggressive” signal, the S&P 500 rose substantially without exception. The average gain was 30.4 percent, not counting dividends. On an annualized bases the gain was 15.9 percent per year. Confining stock investing to these times would have produced substantially more profits than a single buy-and-hold strategy.

During "Caution" signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased a paltry 0.82 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 turn to the Risk Indicator. If the Risk we know the market is relatively high risk. This was indeed the case in Sep-Index of Lagging Indicators flashed a dicator was (substantially) above 2.0, marking the end of the bull market as Five. The market subsequently crashed. cent until the next “Aggressive” Signal dex of Leading Indicators in February month that bear market low point was most stocks suffered greater losses. The

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

Conversely, the market does not suffice" signals when the risk level is low. For example, the 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 "Aggressive" 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 “Caution” 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 log-jammed 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 “Caution” 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 “Aggressive” 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 (See page one for the stats.). **SA**

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