



“Men marry women thinking they never will change, and women marry men believing they will.” Whether this folk wisdom is true about marriage, it is definitely true about investing. But substitute “growth investors” for “men” and “value investors” for “women.” Growth investors look at current trends and extend them forward, which allows extravagant valuations. For instance, I love my Netflix subscription, but with the current P/E at 63 and the forward P/E at 46, the assumptions that must be satisfied to allow the shares to fulfill that expectation are unreasonable. What keeps them going up is a mystery, since when I checked Yahoo! for current analyst opinions, euphoria was not evident. Of 31 opinions on NFLX, only seven are Strong Buys or Buys while nine are Underform or Sell. 15 suggest “Hold.” The mean and median target prices are \$115. Yet shares closed on October 1<sup>st</sup> at \$154.

The flip side includes stocks with loads of problems, no prospects and few friends. Though I probably should keep my voice low about **Boston Scientific**, which doesn't even have a P/E due to massive charges and write offs and is recommended by only four of 26 Wall Street analysts, its recovery prospects remain compelling for investors with steel for nerves or anmesia. Even when the problem is simply the business cycle, a superb company can be punished. **Paychex**, this month's recommendation, despite an excellent quarter, was not rewarded when its numbers were announced. There are few down stocks whose potential for recovery are so clear as PAYX's, and yet investors avoid the company. The irony, of course, is that PAYX was a growth investor's darling during the 1990s. Indeed, the entire notion of companies being either “growth” or “value” propositions is extraordinarily fluid. Today's growth stock can be tomorrow's value stock—and vice versa.

*-Gray Emerson Cardiff*

## Quantitative Easing II

In an online commentary last month (9/24) after the market enjoyed an explosive rally, we noted that TV's talking heads offered several explanations for why the market that day jumped 2%+: a stronger-than-expected durable goods report, the FOMC's ruminations on Quantitative Easing and a hedge fund honcho's very bullish CNBS interview. We opted for the better-than-expected durable goods order rather than the market anticipating Quantitative Easing from the Federal Reserve or, what seemed least likely, CNBC's self-promoting suggestion that its interview (which we had not seen) before the market opened with David Tepper, a very successful hedge fund manager, had touched off that bout of bullishness. We now regret ridiculing Tepper as “some big time investor talking his book on TV and then CNBC claiming that was the accelerant for the blazing prices.” In fact, Tepper did not talk his book, but made general observations about how the painfully slow economic recovery might play out in the bond and equities markets (<http://www.cnbc.com/id/15840232?play=1&video=1598887347>). Much of his scenario depended on the other theme we pooh-poohed: Quantitative Easing. One reason we find his argument so compelling now that we've viewed it, is it's fairly close to what we've suggested since the economy started to stall in the late spring.

Tepper is worth listening to not just because his Appaloosa funds have averaged 30% return for most of this decade (without significant leverage) but also because that success has come primarily from bonds, particularly bonds from distressed companies. Let me stipulate this: bond investors are smarter, or at least are more reality-based, than stock investors, since as a group they pay much more attention to fundamentals, to numbers and, at least the good ones, give little attention to rumors and stories. They are micro investors. But it turns out that Tepper is both a macro and a micro investor.

His biggest wins have come from macro observations that he then applied to specific bonds and stocks. For example, in 2009 he made most of his profits from financial stocks, which, he believed would

The **SoundAdvice** portfolio is up **28.00%** since 1/1/2009

**SoundAdvice vs the S&P 500**

Since 1/1/2000, \$25,000 becomes:

**\$76,749**  
with **SoundAdvice**

**\$23,722**  
with the S&P 500



survive, after the Fed and Treasury had made clear they would not permit the major banks to fail. The rest of the world, having seen Lehman go bankrupt and expecting others would follow, stood back. Instead, the Treasury and the Federal Reserve, made good on their promise and nobody of consequence followed Lehman. For those like Tepper who snapped up the bonds and preferred of distressed banks like Wachovia or Bank of America, it was a bonanza. Appaloosa in 2008 returned 30% to its limited partners. It had a similar coup in 2003 when it bought the debt of disasters like WorldCom and Enron. In that case, Tepper decided that even though the equity holders were heading to zero, the companies' underlying assets were sufficient to reward buyers of their debt at what then were rock bottom prices.

As recently as this August, when the worst pessimism reigned, Tepper was in the dumps: "It just feels very uncertain right now...I'm a natural optimist, but the numbers are just horrid. The whole economy is stuck in mud. Thick. Dark. Mud." He told the *Wall Street Journal* that deflation was on his mind. In the CNBC interview less than a month later, his mood had brightened. Tepper recounted how his mind changed when the Federal Reserve in successive meetings (and in other public comments by its members and associates) signaled that not only was it disappointed by the lack of growth in the economy but that it was prepared, should conditions require, to attack the problem with Quantitative Easing. As we finish off this issue, Bill Dudley, the New York Fed's President and vice chairman of the FOMC just made the clearest assertion that Quantitative Easing is coming (<http://www.newyorkfed.org/newsevents/speeches/2010/dud101001.html>)

Here is how Tepper now views the future: the Fed actively must generate economic growth and, if the economy can't get going soon on its own, will do everything it can to create inflation that will move the economy forward. Quantitative Easing would be—is intended to be—inflationary, something, Tepper asserts, the Fed never before had promoted. "Either the economy gets better by itself," which means that stocks will flourish while bonds and gold will take a back seat, or the Federal Reserve intervenes with Quantitative Easing, which in the near term means

everything benefits, though in the longer term it will be negative for bonds. This perspective has put Tepper back into bonds and his exposure to stocks, not his normal tool of choice, is up even more.

Our only disagreement with Tepper is about history. He's wrong about Washington not stoking inflation as a solution. In 1933, the Thomas Act (aka The Inflation Act) permitted Roosevelt to require the Federal Reserve to expand credit up to \$3 billion (when a "billion" meant something), to issue up to \$3 billion in notes backed only by the full faith and credit of the U.S. government, and authorized him to devalue gold by up to 50%. This was followed by increasing the official price of gold from \$20.67 an ounce to \$35. All of this was highly inflationary and got the desired result. Stock prices exploded for the next four years.

Bernanke, who built his academic reputation as a student of the Great Depression, when he was a freshly minted governor back in 2002, invoked Milton Friedman's metaphor of helicopters dropping vast amounts of cash as a remedy to recession and deflation. Though Bernanke framed this as what the Fed should do were deflation to occur, when we first examined his argument in the February 2003 issue ("Re-Inflation: The New Strategy"), we suggested that, even if neither Bernanke nor Greenspan were willing to acknowledge deflation was then in the air, all facets of government were reacting as if deflation was real. The dollar was cheapened, taxes cut, growth in the money supply was accelerating, government spending was increasing and real interest rates were being forced towards zero.

Eight years later, we are back to the same deflationary predicament and the solution, as Tepper anticipates, should the economy not respond soon, will be Quantitative Easing—as much and as long as it takes. Tepper noted that in the four months before stock prices exploded in March 2009, the M2 money supply rose sharply. After the 2000 market collapse and the first stirrings of recession, M2 growth also accelerated starting in December 2000 and not pausing until September 2003. M2 is starting to accelerate again. We believe our portfolio is well-positioned to take advantage of either of the two outcomes Tepper foresees. SA

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## Paychex: A Proxy for Business Growth

The recurrent theme in our recommendations this year has been companies or sectors that because they are closely tied to the U.S. economy will benefit as we recover. Our rationale is pretty simple (we hope not simplistic): first, such companies' shares remain depressed as long as investors are convinced that a recovery is either not going to occur anytime soon or when it does occur will never be more than shallow and spotty. Though we have no crystal ball to determine when that recovery will become substantial, we're willing to take advantage of the cheap prices such pessimism creates. Second, as that recovery unfolds, revenues and earnings will rise. We should—presuming we are right about a recovery—get a double boost: as revenues and profits rise, investors will become more positive about recovery, which will invite higher valuations to amplify those higher sales and profits. That's the way it should work.

The wonderful aspect of investing during economic downturns is that to find bargains you needn't ferret out dinged up companies that have alienated investors. Instead you have your pick among excellent companies with strong futures. This month's selection, **Paychex (PAYX—Nasdaq)** is as good as they get: a dominant player in the payroll services sector, a debt-free balance sheet, loads of potential for future growth and a 4.6% yield.

Why is a deal like this just sitting there? Any idiot could answer that: the most corrosive aspect of this recovery from recession is the lack of job creation. Fewer jobs means fewer employers either needing to expand or even requiring payroll services. Unemployment is running at just under 10% and if you factor in those who have stopped looking for work, those that are not working as many hours as they need and those who can find only low-paying jobs, the real underemployment figure would be double the official number.

CEOs are sitting on their hands, unsure about whether dispirited consumers need or want what expanded production would bring to market. Corporations are just as indecisive and anxious about the future as the rest of us and are unwilling to expand. In this environment, why own shares in a company that is a proxy for employment levels? From our perspective, what better time could there be to buy them?

Automatic Data Processing (ADP) is the big dog in payroll services. With a \$20.6 billion market cap and \$8.9 billion in sales, ADP markets primarily to medium and especially to large size companies. Paychex, which has a market cap of \$9.9 and \$2 billion in sales, plays a similar role for small businesses. Of its clients, 41% have 1-4 employees, 41% have 5-19, 12% have 20-49, 4% have 50-99 and 2% have 100 or more employees. Though both companies will prosper in any recovery scenario, Paychex, because it focuses on smaller companies, the most dynamic portion of the business world, has a greater potential source of clients. The flip side is that during business downturns smaller companies are more vulnerable. Certainly that is how the market views the relative values for ADP versus PAYX, which has had the weaker share price during and coming out of the recession. Yet, over this same period, Paychex continued to show considerably higher margins. ADP's operating margin is 19.9%, PAYX's 36.2%. ADP's profit margin is 13.6%, PAYX's 23.2%. Paychex, at least from our perspective, looks like the better company.

### Businesses Under Pressure

According to the U.S. Census Bureau as of 2007, the most recent figures on its site, there were 7.7 million businesses in the United States, which accounted for 120.6 million jobs. 5.4 million firms employed 20 or fewer workers for a total of 21.8 million employees and another 723,400 employed between 20 and 99 workers for a total of 20.9 million. When combined, these smaller companies were responsible for 35% of all private sector jobs.

At the time, Paychex worked for 561,000, only 11% of which had more than 20 employees. 2007 marked the beginning of contraction for businesses. The Small Business Administration gauged that after a 4% increase in the number of such companies in 2006, creation of new small businesses slowed in the following years by 0.3%, 6.3% and last year by 11.8%. Over the same period, the worst year for closures was 2008 when 663,900 firms shut down, a 12% jump from 2007. Bankruptcies also soared, increasing from 19,695 in 2006 to 28,322 (+43.8%) the following year and by 53.8% and 39.7% in the next two years. Subtracting closures and bankruptcies from newly created businesses, the number of small businesses

contracted by 81,000 in 2008 and by 169,000 last year. Every time unemployment figures come out, investors are reminded that any business yoked to employment numbers is currently struggling against severe headwinds and they sell

## Paychex

The tedious but crucial task of tallying and dispersing wages was one of the first corporate chores to be outsourced. ADP during the late 1950s pioneered the use of computers for managing payroll records, which was feasible for large clients but not for small businesses. Tom Golisano, PAYX's founder, was working for a payroll company in the early 1970s, and observed that "most businesses have fewer than 100 employees, but most payroll services were going after bigger companies." Like ADP, Golisano made innovative use of technology, albeit less high tech. If he could cut out sending employees to each company to collect payroll information and instead simply let the client phone in the data, he could make his services cost-effective for small businesses and still turn a profit. Golisano called his company PayMaster.

Growth originally came from franchises and partnerships which spread PayMaster from its original base in Rochester, New York to 17 other markets around the country. Eventually that structure became unwieldy and in 1979 the company was restructured with a centralized business model. Paychex went public four years later, earning two cents a share on 41 cents a share in revenues.

The company continued to expand, adding new clients at a 10%+ rate a year and growing revenues at a double digit pace. Paychex relied on its own sales force to contact small businesses but also cultivated CPAs to bring in their own clients. In earlier years, Paychex acquired smaller, regional payroll service companies, but now shies away from that strategy. In the 1990s as new accounts accelerated, Paychex began adding complementary services such as managing benefits data and disbursements and moved into personnel services but none was more important than Taxpay. Just as companies found payroll services onerous, filing and paying taxes on compensation was just as big a headache. Paychex for an additional fee offered to prepare and file paperwork and to disperse the payments.

Thanks to its increasingly more computerized operations, Taxpay's added costs were modest but clients were willing to pay considerably more to hand these tasks to someone else. Paychex estimated that Taxpay boosted revenue per account by as much as 45%. Today 94% of Paychex clients rely on Taxpay. In addition to the fees generated, Paychex also captured income from interest accrued between the time clients funded their payroll tax liabilities and when Paychex made the payments. Even though the holding period could be as short as a single day (though some transactions involve periods as long as 90 days) this profit from the float provided a nice bump to revenues and profits.

Other services not directly tied to payroll followed. In 1991 Paychex began its Human Resource Services division that sold evaluation and testing tools, employee handbooks, and, as government regulation increased, offered clients updates on new laws and the tools to comply with them. Since then, Paychex has provided temporary workers for payroll and benefits as well as insurance and retirement services.

The more time we spend looking at how the payroll services business operates, the more impressed we are by what a profit-generating machine it is. The costs for running an efficient operation are modest and the incremental costs for adding new clients and services are also small. Capital expenditures for Paychex over the years have never been more than 5% of sales. Paychex is a cash cow, and management has never been reluctant to distribute it to shareholders. From 1994 until 2009 Paychex had increased its dividend from 1 cent to \$1.24. For those of us now considering buying Paychex the yield is tempting, since the share price is back to where it was in late 1999 when the dividend was (on a split adjusted basis) just 15 cents. Low share price, robust dividend=4.6% yield.

As Paychex has become more involved with its clients' internal record keeping and activities, its relationship with them has evolved from being merely an outsourcing contractor to being an integral part of their businesses. By offering services that integrate Paychex into businesses' day-to-day work, Paychex reduces the likelihood that a client might switch payroll service companies. The relationship is "sticky."

## The Current Environment for Paychex

The core for Paychex remains its original payroll processing and the add-ons to it. But regardless of how strong Paychex's business model is, now is a difficult time. One sign is that Jonathan Judge, the CEO Paychex selected six years ago to succeed Golisano, in mid-July abruptly resigned in order "to pursue other interests." Golisano, who had continued as Chairman of the Board, stepped in to fill the vacant CEO slot. Last week, Martin Mucci, senior VP for operations, assumed the post. He most likely will work closely with Galisano.

The September 28<sup>th</sup> conference call following filing of last quarter's results was Golisano's most significant opportunity to show where he wants Paychex to go. He didn't disappoint. For example, it would be convenient to blame the economy and excuse both Paychex and by implication Judge for the relative doldrums into which sales and profits had fallen, but Golisano, when asked how much of Paychex performance over the last few years was due to the economy, snapped back "30 percent," and attributed the rest to poor execution. If we can infer from the measures Golisano is taking to remedy that poor performance, we can glean where he feels Judge had fallen short.

Thus, Golisano asserted that the 2200 person sales force needed to be retuned and that the company needed to take its services abroad. The company founder as well as the company's largest shareholder (10%) clearly has an agenda.

Golisano is attacking the sales force problem in several ways. First, Paychex is rebalancing compensation away from salary toward commissions, which means he felt the sales department, the core of for expansion, had become complacent. He also demanded that his sales people know the payroll business inside and out, so we can expect Paychex to spend more on training. He also says that the company is about to rollout new pricing. Products might be bundled to make them more attractive to existing and new clients. However, Golisano was adamant that unlike some of his competitors, Paychex would not price services so low that they became loss leaders. Even domestically Golisano sees ample room for expansion. As he notes, only 15% of America's small businesses use payroll services.

We don't know what foreign expansion Golisano

has in mind, though it was toward the end of his watch that Paychex opened its first and only foreign office in Germany. But Germany, with 1700 clients, a mix of U.S. corporations and German firms, accounts for less than 1% of revenues. Golisano observed during the conference call that foreign governments tend to be "very intrusive" when it comes to employment, which he sees as a strong indicator that Paychex has ample opportunities to grow their international business. If past is prologue, we can expect Paychex to make a small acquisition or two. Any real growth will be organic.

But these initiatives are only now about to be introduced, so the most recent quarter's results, announced two weeks ago, say more about how Paychex is dealing with that "30 percent" of its challenge. The answer seems to be: quite well.

Payroll Services increased sales 2% despite an overall shrinkage of accounts. This is explained by Paychex's ability to increase prices, an increase in its existing customers' use of payroll services and expansion in non-payroll service business. The number of checks cut rose by 1.2%, which follows a 1.1% increase in the previous quarter. Before that, the last time the number of checks cut grew was at the start of 2007. But the number of clients declined again, falling from 536,000 to 532,000, though most of the lost accounts represented businesses that had closed rather than customers dissatisfied with Paychex.

The fastest growing segment (+10%) was Human Resources Services, which provides support and employees for clients' HR needs, employee benefits administration, risk management, retirement services administration, insurance (as an agent) and online products to track benefits and time and attendance. Aside from the obvious boost that this growing segment gives to total revenues (28.1% vs. 69.6% from payroll services), it shows that companies are receptive, even in a downturn, to incur costs to outsource ever more complicated administrative tasks and that Paychex has a natural opportunity as their payroll services company to get that business.

The one area that showed a serious decline was interest on funds held for clients. As noted, the Taxpay program gives Paychex control over funds it then disperses to governments, and even when that holding period is a single-day, money can be made from the float. Paychex also offers customers the ability to

deposit their payrolls into Paychex accounts, from which employees are paid either by check or by cash cards, which also expands the float. But with a slack economy, the amount of funds held for clients has declined and cut into interest revenue. The real problem, however, has been the low interest rate environment that is normal during economic slowdowns, but which the Federal Reserve's aggressive moves to force rates even lower has Paychex—like the rest of us—watching interest income collapse. Compared to 2009, the latest quarter's funds held for clients was off 12% to \$12.1 million. We should note that the investment portfolio is extremely conservative, since almost it backs assets that quickly move off of Paychex books.

This is a classic “buying straw hats in winter” opportunity that offers considerable potential for capital appreciation as well as a yield nearly twice that of the 10-year Treasury. We recommend buying shares up to \$32

The balance sheet is among the strongest we have ever examined: no long-term debt and a \$900 million untapped line of credit distributed among several banks. Given the light cap-ex nature of the business and the strong free cash flow (\$178 million in the last quarter), Paychex shareholders can expect the dividend will be maintained and expanded over time.

During the conference call, analysts repeatedly prodded Golisano or other senior executives to revise the guidance the company had provided earlier this year, since the results for the first quarter had exceeded expectations. To their credit, the Paychex executives refused to enhance their expectations based on a single quarter's better-than-expected numbers. Perhaps this unwillingness to pander to analysts' wish for more ambitious projections accounts for Wall Street's ho-hum response to what had been accomplished under difficult circumstances.

Paychex share price (adjusted for splits and dividends) peaked in late 2000 at \$47.39 along with what was the greatest bull market and economic expansion of our lifetime. During that boom, PAYX's revenues had rocketed averaging 18.6% annual growth—and that included the 1990-1991 recession. Since that peak the adjusted share price has been as low as \$16.62 in August 2002 as the economy and market were heading for a bottom and as high as \$40.91 just before the market began its decline in late 2007. When the market did bottom in March 2009, PAYX closed just over \$19, which is to say that investors sour on Paychex during and in the immediate

wake of recessions. What we are seeing with Paychex is a pattern defined by the business cycle.

PAYX has come back with the rest of the market, but has lagged. The S&P 500 since March 9, 2009 has risen almost 70%, while PAYX has advanced 40%. It's hardly rocket science (nor is it damning) that a company whose revenues are inextricably tied to business vitality and expansion would shed accounts, revenues and shareholders during tough times, nor is it surprising that most investors would remain wary until they had unequivocal evidence that robust growth had returned. After the economic drubbing we've absorbed since late 2007, investor skepticism is at its deepest.

During the relatively shallow 2001-2002 recession, Paychex still grew sales by 9%, cash flow by 8%, earnings by 7.4% and increased its dividend from 33 cents to 42 cents (+27%). This time round, however, the damage to the economy has been so deep that last fiscal year, even though sales barely grew (+0.7%), cash flow and earnings dropped 5% and the dividend, which over the previous decade had increased 11 fold, crept up all of 3% to \$1.24 and this year did not increase at all.

But for value-oriented investors who understand the business cycle, even at its current price (\$27.26), PAYX is trading at very attractive valuations. Going back to 1990 every standard price ratio currently is well below its historical average: Price/Sales is at 4.9 versus an average low of 6.4. Price/Cash Flow is at 17.5 versus an average low of 24.8. Price/Earnings is at 20.6 versus an average low of 30.7. Price/Book is at 7 versus an average low of 8.8. The current yield, another value metric, one that we can put in our pocket, is at 4.6%.

To be more conservative, rather than including PAYX's meteoric share price trajectory in the 1990s (there were eight 3:2 stock splits between 1990 and 2000) if we rely instead on the past decade, which was much less favorable for Paychex's price and price ratios, the current valuations still are compelling. This is a classic “buying straw hats in winter” opportunity that offers considerable potential for capital appreciation as well as a yield nearly twice that of the 10-year Treasury. We recommend buying shares up to \$32.

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# Portfolio Updates

September, instead of being the bust consensus promised, was hardly that. From when we priced the portfolio on September 3rd through October 1st, the Dow added 3.7%, the S&P 3.8%, the Nasdaq 6.1% and the pan-market Wilshire 5000 4.1%. The *Sound Advice* portfolio increased 5.6% with natural resources, technology and healthcare being the strongest performers.

**Seligman Premium Technology Growth Fund**, the September recommendation, is up 4.2%. As we explained in the last issue, STK is structured to return each quarter a fixed distribution that primarily comes from the sale of calls on the Nasdaq 100. In a calm market this is a highly effective strategy, but at times like these, when the prices for the Nasdaq 100 constituents outpace the rest of the market, STK's strategy creates a drag on performance. Note that the fund, which has been acquired by Ameriprise, has changed its name (though retaining the same ticker symbol) to **Columbia Seligman Premium Technology Growth Fund**.

**Third Avenue Focused Credit Fund**, our high-yield (AKA "junk bond" fund) has cut the holding period necessary to avoid being charged for early redemption fees (2%) from one year to 60 days. The purpose of such fees is to discourage speculative trading in the shares. Junk funds have cooled off this year, but have been consistently in the black. Given Third Avenue's expertise in distressed debt, we expect the portfolio to do well, particularly as the economy improves. Since the last letter TFCVX is up 2.5% thanks primarily to its 18.2 cent distribution.

Our best performing funds got a boost from their exposure to international markets and/or a weaker dollar. **Third Avenue Value Fund**, with its weighting toward Asia (63% of the portfolio), in particular Hong Kong, added 9%. A pure international play, **Dodge & Cox International Stock Fund**, posted a 6.1% gain, aided by diminished anxiety about the potential for default by southern European governments, most notably Greece and Portugal. **The Gabelli Global Telecommunications Fund** with nearly one third of its portfolio in Europe and another 13% in Asia benefited from currency trends and surged, adding 5.5%.

Other sector funds also led their comparable ETFs: the **Davis Financial Fund** is up 4.2% and the **Fidelity Select Natural Gas Fund** 4.3%. **CGM Realty Fund** along with REITs took a back seat to sectors that had

lagged this year, adding a meager 0.5%. Ken Heebner, whose history of market-beating performance has been extraordinarily volatile, has never shied away from abrupt overhauls. He's back at it, purging all of his mining positions, which six months ago had accounted for 17% of the portfolio. He now has overweighted his portfolio toward lodging REITs and operating companies. Gone are mortgage REITs, which 12 months before had accounted for a fifth of the portfolio. **CommonWealth REIT** (previously known as **HRPT Properties Trust**) floated a \$250 million bond offering, the proceeds from which will be used to reduce the outstanding portion of its revolving credit line and to redeem its 8.75% Series B Preferred shares. The new debt priced at 5.875%, a cheap number, speaks volumes about the current credit markets. CWH, after rising to \$28 on news of the debt issue, tumbled after announcing it would also issue 7.5 million new shares to be priced at \$26.75. In its filing with the SEC CommonWealth simply announced that it "expects to use the \$191.7 million of net proceeds of the offering (after estimated expenses and underwriters' commissions) to repay amounts outstanding under the Company's revolving credit facility, to fund a portion of its redemption of its Series B Preferred Shares ...and to fund general business activities, including possible future acquisitions." CWH has continued to erode, and closed today at \$25.86. A rush for the exits when a new issue is priced this far below the last sale is to be expected. We've trusted CWH's management to make good use of cash, and are willing to be patient to see how this cash will be deployed. Since the last letter, CWH is down 1.2%.

With the dollar weakening and expectations of a double dip receding, natural resource shares were strong. **USAA Precious Metals & Minerals Fund** continued to move, adding another 6.8% as gold hit a new high above \$1308 per ounce. **Transocean** has been recovering (+18.4%) as visibility clears over responsibility for the catastrophe at the Deepwater Horizon and the extent of the environmental damage. **RIG** has further to run not only because the litigation concerns remain exaggerated but also—and most important—demand for ultra-deepwater expertise and assets means heavy demand for what RIG offers. Expect to see the dividend reinstated as the government of Switzerland (where RIG is legally domiciled) finishes its investigation of RIG's role in the Deepwater Horizon incident and its financial exposure. Finally, don't pay too much attention

Income With Growth	Symbol	Exchange/ Phone	Price/ N.A.V.*	Yield**	Buy Limit	ACTION
CommonWealth REIT***	CWH	NYSE	\$25.86	7.73%	\$28.00	BUY
Telecom New Zealand	NZT	NYSE	\$7.60	9.34%	\$8.00	BUY
<b>Diversified Growth</b>						
Agrium	AGU	NYSE/TSE	\$75.01	0.29%	\$80.00	BUY
CarMax	KMX	NYSE	\$27.79	0.00%	<b>\$32.00</b>	BUY
CGM Realty Fund	CGMRX	800-343-5678	\$24.01	2.57%	N/A	BUY
Dodge & Cox Intl.Fund	DODFX	800-621-3979	\$33.71	1.29%	N/A	BUY
Dodge & Cox Stock Fund	DODGX	800-621-3979	\$97.58	1.12%	N/A	BUY
Fastenal	FAST	NASDAQ	\$53.38	1.57%	\$60.00	BUY
Gabelli Global Telecom Fund	GABTX	800-422-3554	\$20.33	1.77%	N/A	BUY
Honeywell	HON	NYSE	\$44.15	2.75%	\$49.00	BUY
International Speedway Corp.	ISCA	NASDAQ	\$24.46	0.65%	\$31.00	BUY
Johnson & Johnson	JNJ	NYSE	\$61.75	3.50%	\$68.00	BUY
Leucadia National Corp.	LUK	NYSE	\$23.79	0.00%	\$27.00	BUY
Mattel	MAT	NASDAQ	\$23.61	3.18%	\$26.50	BUY
Microsoft	MSFT	NASDAQ	\$24.38	2.13%	\$33.00	BUY
Molson Coors Brewing	TAP	NYSE	\$43.78	2.19%	\$52.00	BUY
<b>Paychex</b>	<b>PAYX</b>	<b>NASDAQ</b>	<b>\$27.26</b>	<b>4.55%</b>	<b>\$32.00</b>	<b>BUY</b>
Pfizer	PFE	NYSE	\$17.18	4.19%	\$19.00	BUY
Stryker Corp.	SYK	NYSE	\$50.01	1.20%	\$55.00	BUY
Superior Industries	SUP	NYSE	\$17.45	3.67%	<b>\$20.00</b>	BUY
Tetra Tech	TTEK	NASDAQ	\$21.19	0.00%	\$26.00	BUY
Third Avenue Value Fund	TAVFX	800-443-1021	\$49.26	2.31%	N/A	BUY
United Parcel	UPS	NYSE	\$66.44	2.83%	\$75.00	BUY
UnitedHealth Group	UNH	NYSE	\$35.43	1.41%	\$38.00	BUY
Wal-Mart Stores	WMT	NYSE	\$53.36	2.27%	\$60.00	BUY
Xerox	XRX	NYSE	\$10.50	1.64%	<b>\$12.00</b>	BUY
<b>Energy/Natural Resources</b>						
Anglo-American PLC	AAUKY.PK	PINK SHEETS	\$20.28	0.00%	\$24.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$28.05	0.19%	N/A	BUY
Plum Creek Timber	PCL	NYSE	\$35.51	4.73%	\$40.00	BUY
PowerShares Water Resources ETF	PHO	NYSE	\$16.61	0.62%	\$19.00	BUY
USAA Precious Metals & Minerals	USAGX	800-862-6909	\$43.62	0.02%	N/A	BUY
<b>Aggressive Growth</b>						
AOL Inc.	AOL	NYSE	\$25.03	0.00%	\$28.00	BUY
Boston Scientific	BSX	NYSE	\$6.07	0.00%	\$8.50	BUY
Comcast	CMCSA	NASDAQ	\$17.82	1.83%	\$21.00	BUY
Davis Financial Fund	DFIBX	800-279-0279	\$22.46	0.00%	N/A	BUY
Ford Motor Convertible Pfd	F.PRS	NYSE	\$47.92	7.28%	\$50.00	BUY
H&Q Life Sciences Fund	HQL	NYSE	\$9.59	6.67%	<b>\$11.51</b>	BUY
Liberty Global	LBTYA	NASDAQ	\$30.62	0.00%	<b>\$34.00</b>	BUY
Maxim Integrated	MXIM	NASDAQ	\$18.46	4.55%	\$21.00	BUY
Seligman Premium Growth Fund	STK	NYSE	\$18.75	9.88%	\$20.00	BUY
Symantec	SYMC	NASDAQ	\$15.40	0.00%	\$20.00	BUY
Third Avenue Focused Credit Fd****	TFCVX	800-443-1021	\$11.07	5.45%	N/A	BUY
Time Warner	TWX	NYSE	\$30.61	2.74%	\$34.00	BUY
Transocean	RIG	NYSE	\$64.35	0.00%	\$75.00	BUY
UltraShort 20+ Treasury ProShares	TBT	NYSE	\$31.54	0.00%	N/A	BUY

 This table has live prices, charts & buy limits on our website: <http://www.soundadvice-newsletter.com>

\* Prices as of Friday, October 1, 2010

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

\*\*\* Name and Ticker changed from HRPT (HRP--NYSE)

\*\*\*\* Covers distributions from Aug 31, 2009 - October 1, 2010

BUY, HOLD, SELL OR LIMIT IN BOLD INDICATES A CHANGE IN ACTION OR LIMIT

to mindless speculation that someone will acquire RIG. If that were to

**Leucadia** is suing Fortescue, the Australian iron-ore mining company that it helped finance, after Fortescue announced it intended to issue new debt. LUK, which holds special notes that guarantee it 4% of Fortescue's profits, and other holders of these notes claim that issuance of new debt will reduce income and thus deprive them of promised revenue. Since the last letter, LUK is up 3%. **Anglo American** is up 5.8% having gone ex-dividend on a 25 cent distribution. **Tetra Tech**, specializing in water remediation, has been battered this year, is recovering, up 10.9% since the last letter after a couple of new contracts were announced. **PowerShares Water Resources Fund**, in which TTEK is a large position, added 5.9%. **Agrium**, the Canadian fertilizer company, increased 3.4%, though the entire sector seems to be cooling off after a torrid run. **Plum Creek Timber** is the only commodity position to not advance, off 0.1% as investors worry about when new construction and demand for raw land will return. With a 4.8% yield, we'd suggest initiating or adding shares.

We've retained our diminished position that is short Treasuries, but continue to get nothing but pain. Why, if we expect Quantitative Easing to happen in the next few months, are we persisting with this position? Consider it a hedge against an end to ever-rising Treasury prices, which are feeding off of expectations that interest rates on longer-term Treasuries will plummet amid QE. Clearly our belief that interest rates had to rise and Treasury prices collapse have not been supported by the events, but we'll hold on to this bet against perpetually falling rates. Since the last letter, **TBT** is off 3.6%.

The strongest contributors this month have been a mix of consumer discretionary shares like **CarMax** (+28.1%), which announced monthly sales numbers that exceeded expectations, hardly cutting edge tech companies like **Symantec** (+10.2%), which benefitted from Intel's decision to acquire McAfee, its biggest consumer-security competitor, as well as the flurry of bidding for companies that are involved in massive data storage technology, which Symantec plays in through its Veritas division and **Xerox** (+16%), whose shares gained from a very positive cover story in Barron's as well as expectations that the company would increase its dividend and also buy back more shares.

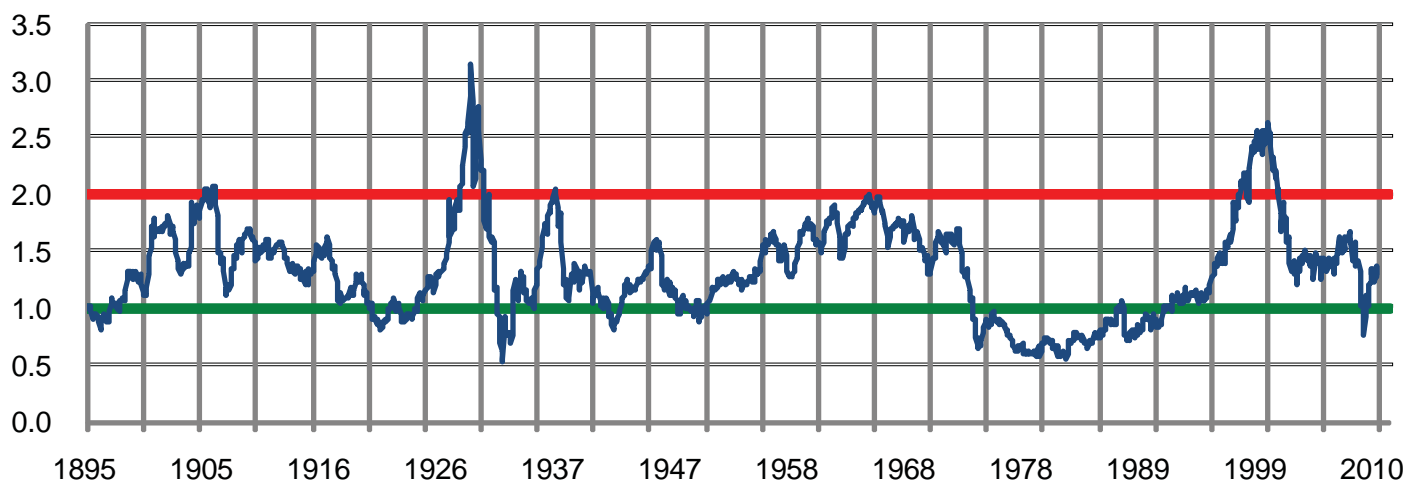
CarMax was not the only auto-related position to have a good month. **Superior Industries** benefitted from excellent earnings reported earlier this month and is up 10.7%. **Ford Convertible Preferred**, which is moving back toward \$50 again, eked out a 2.4% gain.

International Speedways lost four Indy-car events, after the Indy Racing League, which sanctions such races, decided to relocate them. Indy events at ISCA tracks had rarely matched the sell-outs that NASCAR events have been. However, this is an unwelcome challenge for ISCA. Nonetheless, the shares since the last letter are up 1.5%.

**Telecom New Zealand** was rebuffed by the government when it was not included in the first assignments of participation in the plan to upgrade the country's broadband system. The first round distributed responsibility to three other companies and covers about 12% of the nation. Though the remaining 88% is of obvious significance, the real meaning here is that the central government has decided to take a regional approach to building the broadband system. Had the focus been national, NZT would have had a larger share. On the news, NZT dropped 4.8%, but since the last letter recouped that and is up 1.5%.

Healthcare has done well this month, especially our most speculative position, **Boston Scientific**, which jumped 13.5%. Shares were bought after publication of two studies. One demonstrated that BSX's drug-coated stents had better outcomes than did bare-metal stents and the second showed that patients suffering from severe heart-rhythm problems who had defibrillators implanted had significantly improved survival rates after eight years. There also has been a spate of rumors that potential acquirers are circling BSX. We'd rather focus on the reasons the company has value as an ongoing business than on it as dinner for some acquisitive buyer. The long-term value of BSX exceeds the quick profit these rumors reflect.

**UnitedHealth**, which has been doing very nicely since early July, this time lagged our medical positions, up 4.9%. **Hambrecht & Quist Life Sciences Fund**, our biotech closed-end fund, is up 3.2%. **Pfizer** and **Johnson & Johnson** were up respectively 4.4% and 4.8%. JNJ, which lately has gotten a load of bad press for recalls of some OTC products, has been a laggard this year, but Pfizer, which has been in the portfolio only since August has more than doubled the S&P over that period, and that is before we get our first dividend. **Stryker**, maker of orthopedic knees, hips and other body parts as well as hospital equipment, is up 8.5%. We continue to think as healthcare reform moves from law to implementation that good things are ahead for the entire sector. We know, this is not the song Wall Street and the media have been singing ever since 2008, but if you combine the demographic tide of baby boomers and those newly covered by insurance to existing demand, we can't see how healthcare stocks will turn out to be losers. SA



The Risk Indicator measures the overall risk in the stock market by plotting the ratio of stock prices to home prices. See *The Science of Making Money in Turbulent Stock Markets* for a full explanation of the Risk Indicator and the Diffusion Indexes. Median home prices have been flat for the last ten months, so the risk indicator is primarily a reflection of stock prices. The latest reading is 1.40. This reading reveals that stocks are still below their average relative to house prices, and present a better value. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

## The SoundAdvice Diffusion Indexes

The Diffusion Index of Leading Indicators gives “Aggressive” signals when all four of its individual leading economic indicators drop below their respective levels

### Track Record of the 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 produces an annual return of 20.6 percent. During “Caution” signals, the market was all over the place — sometimes crashing, sometimes meandering, and occasionally advancing. On average, the S&P 500 increased at an annual rate of only 1.62 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.12	Apr-76	101.90
Nov-79	100.00	Oct-83	167.65
Dec-84	164.48	Jun-85	188.89
Jul-86	240.18	Aug-87	329.36
Mar-88	265.74	Jun-88	270.68
Mar-89	280.00	May-89	313.93
Oct-89	347.40	Mar-93	449.74
Feb-97	798.38	Dec-98	1,141.00
Oct-00	1,429.40	Dec-00	1,320.28
Jun-03	974.50	May-05	1,191.50
Jul-06	1,276.66	Mar-08	1,325.43
Apr-09	865.33		

of six months earlier, providing a zero percent reading. This reveals a soft economy and a ripe atmosphere for a lasting decline in interest rates.

As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators would hit zero in March, 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.

An “Aggressive” signal coming at a time when the Risk Indicator is close to 1.0 reveals that Supercycle 5 has come to an end, and that Supercycle 6 is born. See *The Science of Making Money in Turbulent Markets* (which you received with your subscription) for a history of Supercycles. You will also receive an updated copy when you renew your subscription. The current reading is 25 percent, which does not change our market perspective. That will change only with a signal from the Lagging Indicators.

The 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. This reveals a strengthening economy and inflationary pressures ahead. Our next signal will come from this Index. This Diffusion Index currently stands at 33 percent.