SoundAdvice

Hulbert's Honor Roll: 2011 - 2016
For the Best Risk-Adjusted Returns in Both Up & Down Markets since 2000

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A Tale of Two Scenarios for 2016

For the sixth year in a row, *Sound Advice* made Hulbert's Honor Roll again as one of the best 10 newsletters having the best performance in both up and down markets since March 31, 2000. According to Hulbert's independent tracking, *Sound Advice* produced an annual return of 9.8 percent since March 31, 2000. This compares to 2.1 percent for the S&P 500.

Hulbert says about the Honor Roll:

"To make it onto the HFD's Newsletter Honor Roll, a newsletter must exhibit above-average performance in both up and down markets.
It shouldn't be all that difficult to jump over these hurdles, but it is: Just 14% of the HFD-monitored newsletters were able to. This suggests that we pay close attention to the Honor Roll. Another reason to do so: On average over the last year, the newsletters on last year's Honor Roll outperformed those that were not. We've seen a similar pattern in almost every year since the mid 1990s."

The *Sound Advice* Portfolio was down 0.93 percent in 2015, as compared to down 0.73 percent for the S&P 500. We have an average profit of 46 percent based on the prices at which each position was recommended.

Happy New Year!

-- Gray Emerson Cardiff, Editor

It was the best of times, it was the worst of times, for many stocks and industries in 2015. The market as a whole ended the year essentially the same place it began, down 0.73 percent.

As we assess the prospects for the markets for 2016, a primary consideration is the probable path for interest rates. Since our last issue, the Federal Reserve's Federal Open Market Committee (FOMC) unanimously decided to begin normalizing interest rates at its December 16 meeting. It increased the Federal Funds rate to range from 0.25 to 0.5 percent from the near zero level established 7 years ago to bail out the economy from the 2008-09 melt-down. The FOMC also voted to raise the discount rate by 0.25 percent to 1.0 percent.

Now that the normalization process has begun, the critical question now becomes how fast will interest rates rise? This question is critical because the slope of the rise ahead will determine the health of the stock and bond markets.

The December Dot Plot

As part of the FOMC's economic projections, each of the 17 members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot", and medians are taken to formulate the Federal Reserve's official prediction.

The most recent Dot Plot taken at the December 16 meeting predicts that the Federal funds rate will be 1.375% by the end of 2016. Of particular interest in the details of these Dot Plots is the sharp difference in the predictions among this group of these informed FOMC experts. The lowest prediction was that the Federal funds rate would end 2016 at 0.875 percent. The highest was 2.125 percent. That is a big difference and represents two diverse scenarios.

The low prediction assumes the recent low interest rate environment will continue. In order for that to happen, three major trends must remain in force:

- Energy prices would continue declining throughout the year.
- In addition, quantitative easing and expansionary monetary programs would need to continue outside the US without having the desired effect of stimulating economies abroad.
- Most importantly, the US inflation rate would need to remain near zero.

That seems like an unlikely scenario because all of these conditions would need to persist unanimously throughout the year.

On the other hand, the high end of the 2016 FOMC prediction of 2.125 percent assumes that all three trends will be reversed. That seems more likely.

Consider Chair Yellen's statement during the press conference following the Federal Reserve's December 16 FOMC meeting:

"The anticipation of ongoing economic growth and additional improvement in labor market conditions is an important factor underpinning the Committee's confidence that inflation will return to our 2 percent objective over the medium term. Overall consumer price inflation--as measured by the price index for personal consumption expenditures--was only 1/4 percent over the 12 months ending in October. However, much of the shortfall from our 2 percent objective reflected the sharp declines in energy prices since the middle of last year, and

the effects of these declines should dissipate over time."

This means that when energy prices stop declining and merely stabilize, the FOMC committee expects that inflation will increase significantly. Of course, any recovery in energy prices would add to inflationary pressures.

Outside of food and energy, US core inflation was up 1.3 percent in the latest reading for November compared to a year ago. This was the 11th consecutive month core inflation has increased at a 1.3 percent yearly increase. This string of readings was during the slide in energy prices which cannot continue indefinitely. As we discuss in the preface to our energy holdings, energy prices are almost certain to be close to their lows.

It is also unlikely that quantitative easing and expansionary monetary programs will not stimulate economies abroad, like they have in the US. The wildcard is China, where economic conditions are uncertain and information is not completely trustworthy. However, Chinese monetary policies need to continue stimulating growth as the economy continues moving from an export-driven to a consumer-lead economy. Barring a melt-down in China, economic conditions outside the US are bound to be improving in 2016 under the propulsion of expansionary monetary policies.

If inflation rises to 2 percent in 2016, it is not unreasonable to predict the Federal funds rate would rise to 2.125 percent, which would only provide a real return of 0.125 percent.

ETFs for Rising Interest Rates

We are recommending three ETFs designed to benefit from the normalization of interest rates and long term bond yields. These ETFs differ in the amount of leverage used, and you can choose among them depending on your investment objectives and risk tolerance.

The **Direxion Daily 20 Plus Year Bear 3 Shares (TMV)** uses 3:1 leverage.

The **Proshares UltraShort Lehman 20 Plus Year Treasury (TBT)** uses 2:1 leverage.

The **Proshares Short 20 Plus Year Treasury (TBF)** uses no leverage.

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds. The prices of these ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. The median points of the most recent December Dot Plot predicts that the Federal funds rate will increase from 0.25 percent currently to 1.375% by the end of 2016, 2.375% by the end of 2017, and 3.25% by the end of 2018.

Long-term Treasury bond yields generally move in accordance with changes in short term rates because investors usually want a real rate of return (above the inflation rate) of approximately 3 percent. Such is the case today. Inflation, including food and energy, has been bouncing around at zero to 0.3 percent annual rates during the last several months. Meanwhile, long term Treasury bond yields have been close to 3 percent (closing at 3.02 percent on December 31 with the Federal funds rate at 0.25 percent).

If we assume long-term Treasury bond yields rise by the same amounts (to preserve the same as today's real return) as the December Dot Plot, long-term Treasury bond yields would be yielding 4.145% by the end of 2016, 5.145% by the end of 2017, and 6.02% by the end of 2018. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 2.145% over the inflation rate at the end of 2016 and 3.145% over the inflation rate at the end of 2017.

Here is what would happen to each ETF:

TMV would rise to $50 by the end of 2016, to $78 by the end of 2017, and to $111 by the end of 2018.

TBT would rise to $64 by the end of 2016, to $87 by the end of 2017, and to $111 by the end of 2018.

TBF would rise to $30 by the end of 2016, to $35 by the end of 2017 and to $39 by the end of 2018.

For context, we can look at scenarios for the low and high ends of the December Dot Plot projections.

The Low End

The lowest points of the December Dot Plot predict that the Federal funds rate will be 0.875% by the end of 2016, 1.875% by the end of 2017, and 2.125% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these lowest points, long-term Treasury bond yields would be yielding 3.645% by the end of 2016, 4.645% by the end of 2017 and 4.895% by the end of 2018.. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 1.645% over the inflation rate at the end of 2016 and 2.645 % over the inflation rate at the end of 2017. These are historically low real rates of return.

Here is what would happen to each ETF:

TMV would rise to $39 by the end of 2016, to $62 by the end of 2017, and to $68 by the end of 2018.

TBT would rise to $55 by the end of 2016, to $75 by the end of 2017, and to $80 by the end of 2018.

TBF would rise to $28 by the end of 2016, to $32 by the end of 2017, and to $33 by the end of 2018.

The High End

The highest points of the December Dot Plot predict that the Federal funds rate will be 2.125% by the end of 2016, 3.375% by the end of 2017, and 3.875% by the end of 2018. Assuming long-term Treasury bond yields move in accordance with these highest points, long-term Treasury bond yields would be yielding 4.895% by the end of 2016 6.145% by the end of 2017, and 6.645% by the end of 2018. With inflation reaching the Federal Reserve's target of 2%, long-term Treasury bond yields would be yielding 2.915% over the inflation rate at the end of 2016 and 4.165 % over the inflation rate at the end of 2017. This scenario is reasonable for 2016 but implies that inflation would be rising above 2% in 2017 and required additional tightening by the Federal Reserve.

Here is what would happen to each ETF:

TMV would rise to $71 by the end of 2016, to $121 by the end of 2017, and to $144 by the end of 2018.

TBT would rise to $82 by the end of 2016, to $117 by the end of 2017, and to $132 by the end of 2018.

TBF would rise to $34 by the end of 2016, to $40 by the end of 2017, and to $43 by the end of 2018.

A Matter of Degree

In any case, there is considerable upside in these ETFs from their current prices. It is only a matter of degree. As we have pointed out in the past, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields. This erosion factor is nominal in comparison to the price swings caused by a change in bond yields, but it can become significant over an extended period of time.

Hedging the Portfolio

In any case, 2016 promises a rising interest rate environment which is not positive for stocks. This comes after a long rise in stocks, at a time when the stock market is dangerously high, based on the 1.3 ratio of the total capitalization of the stock market (stock prices of all publicly traded companies multiplied by their respective amounts of shares outstanding) to the gross domestic product (GDP) of the US. This ratio rose above 1.2 in the late 1990s prior to the 2000-02 bear market that took stocks down nearly 50 percent. It also rose above 1.1 just prior to the 2008-09 bear market which took stocks down nearly 50 percent again.

In our June 29, 2015, issue, we announced that the *Sound Advice* Diffusion Index of Lagging Indicators (page 11) rose to 100 percent, issuing a caution signal. Just to eliminate the possibility of a fluke reading, we note that there have been 8 subsequent readings of 100 percent in a row, including the most recent reported in December for November. (Just one would be sufficient for a caution signal).

From this perspective, we can conclude that stocks in general are precariously high, particularly with rising interest rates on the horizon and our Diffusion Index of Lagging Indicators issuing a string of caution signals. At times like this, it is vital to confine portfolio selections to special situations and focus on value.

The plethora of warning signs has prompted the addition of an ETF that will benefit from a declining stock market.

The **ProShares UltraShort S&P 500 (SDS)** is a reverse ETF that is designed to produce two times the daily fluctuations of the S&P 500 index. A decline of say, 1.0 percent in the S&P 500 will cause SDS to increase by 2.0 percent. Conversely, an increase in the S&P 500 will cause SDS to decline in the same fashion. We have been tracking SDS and confirmed that it performs as it should, with daily premiums and discounts within 0.5 percent. It is also very liquid.

As with any reverse ETF, SDS will erode slightly over a long period of time because it will decline slightly more than it will increase with an equal movement in the S&P 500. The erosion factor is nominal in comparison to normal market movements, but it can add up over an extended period. The 2:1 leverage amplifies this erosion factor as well.

Accordingly, SDS is not a long-term holding proposition. However, for the near term, it will serve as a counter-balance to the rest of our portfolio in a general market correction. The 2:1 leverage factor means that it will better serve this purpose without making a large investment. It is also in the aggressive segment of our portfolio. See the table on page 9.

Energy Selections

The industry has been decimated by the oil glut, and impaired the value of oil and gas properties. US oil-and-gas producers have written down the value of their drilling fields by more in 2015 than in any full year in history, even more than the previous record set in the 2008 melt-down.

Saudi Arabia announced again in December that it is not going to reduce its output, after pumping 10.13 million barrels in November, which was down from record levels but higher than the 9.58 million barrels pumped a year ago. Also weighing on energy prices was the potential supply from Iran when sanctions are lifted.

While the near term still looks bleak and uncertain, the longer term does not.

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Not even the major Middle East oil producers can survive cheap oil indefinitely. The low price of oil is inflicting pain to Saudi Arabia, which is grappling with a record $134 billion budget deficit (15 percent of GDP). The Kingdom must cut government spending. It is also reducing energy subsidies for its residents by charging them more for their consumption. At midnight on December 30, petrol and other fuel products were hiked 50 to 80 percent. International Monetary Fund warns that Saudi Arabia, as well as Oman and Bahrain, will run out of cash in 5 years or less with oil under $50.

Iran's oil industry needs resuscitating. Decades with little foreign involvement and the devastatingly long Iran-Iraq war in the 1980s crippled Iran's oil industry. Its largest fields have been in production for more than 50 years without adequate attention and maintenance since the Islamic revolution in 1979. Substantial amounts of foreign investment, along with western technology, will be required to raise Iran's production significantly. However, low oil and gas prices have made that proposition less attractive and practical. Moreover, oil companies everywhere have dialed back their own capital expenditure budgets in order to survive. It is unlikely that the massive amounts of necessary capital will come until energy prices have recovered and the outlook becomes favorable.

Iran also claims to have oil in storage, but the vast majority of that oil has sulfur and mercury content that is too high to be competitive on world markets.

In December, Congress ended the US crude oil export ban established after the 1974 Arab Oil Embargo. The ban was intended to make the US less dependent on imported oil. Evidently, Congress believes we no longer have to worry about that because of the current glut of oil.

As of December 25, the latest week for which data is available, there were 487.4 million barrels of oil in US storage tanks. During the last 4 weeks, the US imported an average of 7.89 million barrels per day. This means that all of the oil in US storage tanks amounts to only 62 days of oil imports into the US. In 1974, the US only imported 3.5 million barrels per day, slightly less than half of what the US imports today. We are still dependent on imported oil, just as much as we ever have been.

The price of oil has fallen below the cost to drill, causing new US drilling to practically cease. Existing US production will continue to fall off because of the nature of fracked oil wells. Production drops 70 percent during the first year from the typical fracked well. This requires a substantial amount of new wells to be added to maintain overall production levels. That is not happening as evidenced by the 50 percent plunge in the domestic drilling rig count since October 2014.

US production has been tapering off since the peak in early June. US production is down by 408 thousand barrels per day. As production continues to decline and becomes more pronounced, draws from storage tanks are certain to be substantial. That means the US oil glut will disappear.

As it has in past cycles, a recovery in oil and gas prices is bound to translate into stellar profits from carefully chosen oil and gas stocks. Here are updates to our energy portfolio, in alphabetical order.

Chevron (CVX) is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling, to transporting and refining, and even to retail sales at its gas stations. Profits vary from these various stages of production, depending on price demand for oil and for refined products. High oil prices boost margins from drilling but squeeze margins from refining. When oil prices are low, profit margins expand from refining, but not nearly enough to offset declines in drilling profits. This quarter is a case in point. While drilling (upstream) profits were poor, profits from refining (downstream) were higher, which helped balance overall earnings.

The company's currently depressed earnings do not quite cover the dividend. However, management has pronounced the annual dividend of $4.28 per share as “sacrosanct.” As such, the high current yield puts a floor under the stock price while we wait for a recovery in oil prices.

Chesapeake Energy (CHK) has taken a beating from the crash in oil and gas prices. After watching oil and gas prices fall into new lows in December, Morningstar (http://www.morningstar.com) dialed back its future price projections and lowered CHK's current fair market value valuation to $13 per share, down from $19 following the third quarter release of the company's latest third quarter financials.

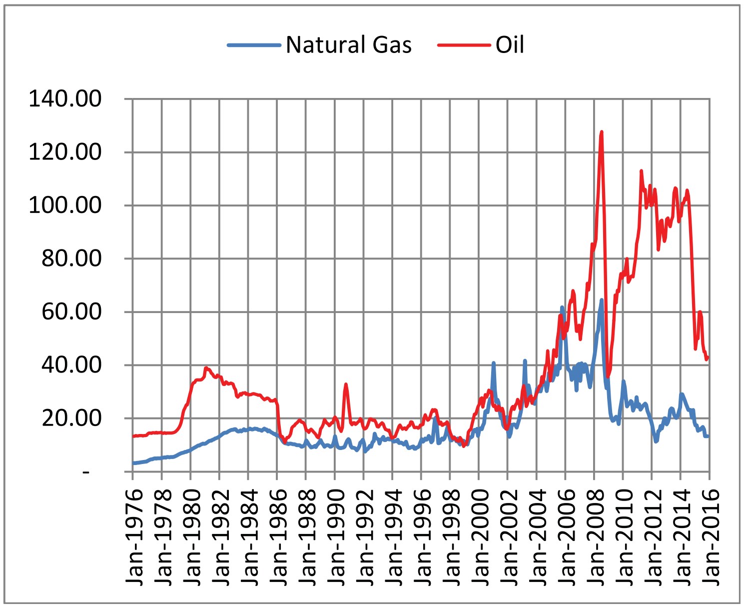
Chesapeake's debt makes it an agressive play, with considerable upside. Managment is taking steps to shore up the company's balance sheet. In the final days of December, the company restructured $3.8 billion of its $11.6 billion debt by exchanging some existing bonds with longer maturities which will make it easier for Chesapeake to survive the current crunch.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the recovery of the natural gas industry through strong companies. Natural gas provides the same energy as oil for pennies on the dollar, and natural gas is more environmentally friendly.

The drop in the price of oil brought the energy-equivalent costs of oil and natural gas closer, but a substantial disparity still exists. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At $37 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas close to $2.22 for one million BTUs, 5.8 million BTUs will cost $12.88. So the same amount of energy is available for 35 cents on the dollar, if it is in the form of natural gas rather than oil.

An updated chart follows, showing the historic relationship between the costs of these two forms of energy. The red line shows the price of a barrel of oil since the mid-1970s. The

The Cost of Energy Equivalents of Oil and Natural Gas



blue line shows the price of natural gas multiplied by 5.8 to approximate the same amount of energy contained in a barrel of oil. Most of the time, the costs of the two forms of energy have been closely aligned. They have moved closer together, but remain substantially apart. This difference still translates into an expanding natural gas industry.

ICON Energy Fund Class S (ICENX) is also a diversified way to participate in the recovery with a basket of substantial companies. The hallmark of this fund has been its ability to look for changes within the energy sectors to capture value, rather than simply depending on rising oil prices. For example, the profit margins expand on pipelines when the price of oil is low, because the cost and price of storage and transportation have little to do with the price of oil.

In the past, this fund has achieved growth even during periods of declining and volatile energy prices. During 2016, management is looking for signs of stabilization in forward looking earnings, and will reposition the Fund as valuations dictate. For example, the recent sell-off of the oil and gas storage & transportation industry has provided an entry point to overweight in this industry.

This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis.

Transocean (RIG) makes deep-water drilling rigs and leases them to major oil producers around the world. RIG has been sharply impacted because the utilization of its rigs has fallen along with the drop in oil prices. We continue to recommend RIG of its prospects of survival. The company still has a $17 billion backlog with $5 billion in liquidity. Deep water drilling is still a necessary source for the US and the world's oil needs, especially as US fracking drops off. Long-term profits from RIG should be stellar from here.

Valero Energy (VLO) is the largest oil refiner in the US. It owns 15 refineries with a capacity for 2.9 million barrels per day. The company also has 7,400 retail outlets in the US, Canada, UK, and Ireland. Valero is one of the few energy companies that can benefit from lower oil prices because refining margins generally expand during such times. Valero's has the most flexible refineries, allowing the company to capture the highest margins among its competitors. Valero's refineries are also well positioned geographically, even for accessing the low-cost Maya crude from Mexico, heavy sour oil that Valero buys for an even larger discount than from glutted US oil.

VLO's earnings are expected to be in the vicinity of $8.00 per share in the year ahead, which puts VLO's forward price/earnings ratio (P/E) close to 9. -- a very low P/E for any stock and a deep discount from the overall market.

VLO also just hiked the quarterly dividend by 25 percent to 50 cents per share, which brings the current yield slightly under 3 percent.

Real Estate Selections

Low interest rates for so many years have pushed down real estate capitalization (cap) rates (the yield before debt payments are considered) to historically low levels. As a result, commercial real estate prices are historically high, and the average real estate investment trust (REIT) does not present a particularly good value.

In the longer run, a rising economy will push up rental rates which will more than compensate for added interest expenses caused by rising interest rates. However, this benefit is most likely to translate into profits only on real estate stocks offering an extraordinary value now.

Hersha Hospitality (HT) is selling at a discount to its hotel assets. Based on the latest third quarter financials, we value HT at $29.22 per share. We expect this value to increase because most of HT's major properties have been undergoing renovations and not producing their full income potential. Income is rising from new acquisitions and completed renovations, as evidenced by the year-over-year 17.7 percent increase in third quarter funds from operations (FFO), following the second quarter's increase of 13.9 percent.

Retail Opportunities Investment Corp (ROIC) began as an IPO in October 2009, just after the REIT sector had been decimated by the 2008 melt-down. It started with a fresh slate in a real estate market replete with bargains. ROIC buys distressed retail properties with high-quality demographics, refurbishes them, and then leases them at a premium. As new properties are added, along with tenant upgrades, funds from operations (FFO) are bound to continue to rise. ROIC also pays an attractive dividend which lowers its risk profile.

Third Avenue Real Estate Value Investor Fund (TVRVX) is replete with stellar values substantially below NAV with strong growth prospects.

Management has a similar approach to ours because it is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams to come up with their estimates of intrinsic value. An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

TVRVX has a number of distinguishing characteristics. This is a global real estate fund. Management looks for growth more than current income by focusing on real estate operating companies which, unlike REITs, can reinvest profits back into the business. Management also looks for opportunities in different points of a real estate company's capital structure by investing in senior debt in addition to a company's equity. Also unlike the typical REIT, management will go to cash when asset prices are generally high. Cash is preserved for scooping up opportunities in distressed times.

Specifically, the management team looks for 4 fundamental characteristics before making investments:

1) The issuer has an especially strong financial position.

2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").

3) There is comprehensive disclosure including reliable audited financial statements.

4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

Medically-Related Selections

This sector is defensive because medical needs persist regardless of financial conditions. The world's inexorable demographic aging trends and the commensurate increase in medical care needs translate into strong growth prospects for this industry.

Boston Scientific (BSX) produces medical products that are well suited for an aging population. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX has more than 900 US patents.

Pfizer (PFE) has an arsenal of new pharmaceutical products, with 88 in clinical development and 30 in late stage development or registration. PFE has rebuilt its pipeline and transformed its R&D approach. The company is well positioned with several break-through drugs and treatments.

Late in November, PFE and Botox maker Allergan agreed to merge, creating the world's biggest pharmaceutical company in terms of sales. PFE would domicile in Ireland which will result in lower tax rates. Allergen stockholders will receive 11.3 PFE shares for each Allergen share. Pfizer claims that it makes all of its profits overseas, and the corporate inversion will save $2.2 billion in US taxes which will be a boost to earnings.

Stryker (SYK) provides a diverse array of innovative medical technologies, including reconstructive, medical and surgical, as well as neuro-technological and spine products, although SYK is best known for its orthopedic devices for artificial knees and hips. Continued growth is assured by accelerating demand for joint replacements on aging US baby boomers. As life expectancies continue to increase (and obesity trends continue), more and more hip, knee, and spinal procedures will be needed.

Stryker's cash-rich balance sheet and strong cash flow give it avenues for continued diversified growth through acquisitions. The most significant recent acquisition was MAKO Surgical, which recently received FDA clearance for its knee and hip applications, enhancing SYK's robotic reconstructive solutions. Other recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL) is in our portfolio because the most explosive profits in the entire healthcare industry can be found in biotech companies. Over the last 10 years, biotechnology has become a major industry which now provides the world's top drugs. This sector has outperformed the broad market during the last one, five, and ten year periods.

Biotech companies tend to be high risk and high reward investments which makes diversification essential. This fund is an excellent way to invest in this sector.

Small Caps

Numerous studies show that small caps perform better over the long run than the market as a whole. This is especially true during a recovering economy. Small-cap stocks perform better than large-cap stocks because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually quite profitable. They also tend to be domestic companies without substantial overseas exposure, and therefore are not buffeted by the currency fluctuations that currently haunt larger companies. Here more than ever, attention to value is paramount. In December there was a distribution of $2.7566 per share.

Third Avenue Small-Cap Value Investor Fund (TVSVX) invests in companies with small capitalizations using the same value-oriented approach as it does with its real estate value fund. TVSVX management scours the investment universe for companies that combine the three main features: creditworthiness, a meaningful discount to a conservatively estimated net asset value (NAV), and the ability to consistently grow NAV, with an initial targeted holding period of three to five years. A patient and price conscious acquisition is a critical first step in both protecting capital and in realizing an attractive investment return.

Special Situations

The rest of our portfolio falls into other market sectors, with companies that are presenting extraordinary values within their respective industries. Here they are in alphabetical order.

Agrium (AGU) is a Canadian company offering a broad mix of agricultural products, from wholesale fertilizers to retail farm products, aimed at increasing the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while population and per-capita income increases. This translates into a need for greater crop output per acre through the use of AGU's products.

Close to one-half of AGU's earnings come from its retail stores offering farm products, and the other half comes from its wholesale sales of fertilizers, mostly nitrogen-based but also from potash and phosphates. This diversification protects AGU from swings in the markets and brings steady sources of growing free cash flow for future growth.

AGU is trading at close to 12 times next year's earnings estimate of $7.25 per share. This is a good value with a growing dividend which was increased again to $0.875 per quarter.

Alcoa Aluminum (AA) was introduced in our December 9 e-mail blog. Alcoa has been crushed along with other commodity stocks this year. The 52-week range is $7.81 to $17.10.

Alcoa is a fully integrated aluminum producer, which means it operates in all phases of production, starting with its mining operations (upstream) and ending with its finished products (downstream). Alcoa's full integration gives it control over the supply chain, and makes it possible to enjoy larger profits from its downstream operations when aluminum prices are low.

In the first half of next year, Alcoa will be splitting its upstream and downstream operations into two separate companies. Management is making this move to unlock value, and we believe it is certain to do just that.

The Upstream Portion

It's no secret that mining operations have been suffering under the pressure of low aluminum prices. For the near term, there doesn't appear to be much to be optimistic about. China state-owned enterprises (SOEs) have extensive mining operations which have been adding to supplies, and this will likely continue next year. To lower costs, Alcoa is opening a new smelting facility in Saudi Arabia to take advantage of the low cost for the large quantities of energy needed for this process. This will be the lowest cost smelter in the world.

The dismal results this year and the bleak outlook for the mining operations have crushed the stock price, to the point that the virtues of the upstream operations are being heavily discounted.

Downstream Growth

In sharp contrast, the rest of Alcoa's operations are prospering, and offer dependable and exciting growth prospects. This side of the company fabricates aluminum-based material for many industries.

Two recent acquisitions have bolstered Alcoa's ability to increase profits and production of finished aluminum. Firth Rixson was purchased in 2014 to accelerate growth in jet engine components. The titanium producer, RTI International Metals, was purchased in March, 2015.

The majority of Alcoa's downstream revenue (57 percent) comes from the aerospace and automotive markets. Alcoa sees an industry backlog of orders for 14,000 commercial and regional jet planes which represents 9 years of production at recent rates.

While aerospace is the largest source of revenue (39 percent), demand from automakers is projected to be the strongest source of growth because nearly all 2016 revenue is already secured through long-term contracts. Alcoa's "Micromill" technology provides aluminum's light weight combined with the high strength of steel. Micromilled products are planned for components of Ford's 2016 all aluminum and best-selling F-150 truck.

Ford has led the way with its F-150 truck which gets 30+ miles to the gallon. All automakers are shifting to aluminum vehicles to comply with the new Federal standards requiring cars and light trucks to have fuel efficiencies of 35.5 miles per gallon in 2016 and 54.5 miles per gallon by 2025.

Valuations

Splitting the company is revealing. Earnings for the upstream side of Alcoa are estimated to be 70 cents per share in 2016, based on company guidance and the consensus of Wall Street estimates. Comparable companies trade at a price/earnings (P/E) ratio of close to 19 on average. Using a P/E of 19 for Alcoa's upstream businesses produces a value above $13 a share for AA. In an effort to be conservative, a P/E of 15 (below the market average) produces a value of $10.50 for AA.

With the stock currently under $9.00, we are buying Alcoa's flourishing upstream business at a discount, and we are getting the downstream business for free. For the longer-term, it seems hard to go wrong with AA at the current price.

Disney (DIS) released its widely anticipated *Star Wars: The Force Awakens* on December 18 in more than 4,500 theaters (the most ever) along with the exclusive use of every IMAX screen in the US. The box office gross of over $1 billion in the first two weeks eclipsed the previous record held by *Jurassic World* which had the benefit of opening simultaneously in China. *Star Wars* will open in China, the second largest market, on January 9.

Disney plans several more episodes and related offshoots of the *Star Wars* franchise into 2019, along with more *Indiana Jones* movies. More *Avengers* and *X-men* movies are in the making for 2016.

The success of these movie franchises will add to investor enthusiasm and make DIS less dependent on its cable TV stations, especially ESPN, which are under pressure from cable platforms offering skinnier bundles.

Ford (F) reported strong third quarter earnings in late October of 45 cents per share, up 89 percent from one year ago. As we have been pointing in previous issues, earnings have been depressed because of down time and preparation for 24 new or refreshed vehicles, including Ford's new all-aluminum F-150 truck which weighs 700 pounds less than last year's model and gets close to 30 miles to the gallon. The F-150 is Ford's best-selling vehicle in the US and the company's most profitable product, even as volume has been held back by production capacity.

On the cost side, Ford is reducing the number of platforms it uses to produce its models, from 27 in 2007 to 9 by 2016, which will save billions of dollars through economies of scale, and give Ford more agility to adapt to changes in demand.

Earnings are expected to be $1.93 next year, putting the forward price/earnings (P/E) ratio below 7. This P/E ratio is far too low for a stock offering a solid dividend along with growth prospects.

*Calculated by the Hulbert Financial Digest

Freeport-McMoRan Copper & Gold (FCX) is the world's largest copper producer. It also has significant oil and gas assets which it acquired at the top of the market in 2013. This was particularly unfortunate because FCX took on a large amount of debt to make the acquisition. The added leverage, along with sinking prices on these commodities, has decimated FCX.

Activist investor Carl Icahn has recently invested in a stake of 88 million shares of FCX, which makes him its largest shareholder. Mr. Icahn usually has a plan in mind aimed at fixing the current problems, and coercing management into adapting his ideas. These ideas are certain to include a "significant" reduction of its $20.7 billion debt. Meanwhile, FCX is worth holding for a better day.

NCR Corp (NCR) makes automatic tellers (ATMs), retail point-of-sale (POS) workstations, self-service kiosks, and other self-service checkout systems. 485 million people use NCR products every day, and there is room for substantial growth in the US and around the world.

The December Dutch offer was oversubscribed, with approximately 41.2 million shares of NCR tendered. The company purchased approximately 37.4 million shares, approximately 22 percent of the outstanding shares, at $26.75 per share for $1 billion.

Most of the funds for the Dutch auction were provided through a deal made with Blackstone, whereby Blackstone purchased $820 million in convertible preferred stock that is perpetually convertible into NCR common stock at $30 per share. This gives Blackstone equity in 27.3 million common shares when it rises above $30. This is a dilution of close to 14 percent. However, the dilution is more than offset by NCR's purchase of $1 billion in NCR stock in the Dutch auction.

The overall transaction should be positive for NCR in the longer run. This is because Blackstone will have an on-going stake in NCR. Blackstone has a successful track record with investments such as this. Blackstone is a savvy private equity and advisory firm, and evidently sees that it can accelerate NCR's transformation into a software-driven business, and add significant value to NCR above $30.

We have stressed in the pages of *Sound Advice*, that NCR is an undervalued stock, even at $30. Blackstone obviously agrees.

Symantec (SYMC) is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. Nearly all of the Fortune 500 companies are Symantec customers. According to Symantec's latest annual Internet Security Threat Report, cyber-attacks against large corporations have jumped by 40% this year. If there ever was a more certain growth industry, protection from cyber espionage is it.

The sale of Symantec's subsidiary Veritas will close on January 29 to the Carlyle Group for $6.3 billion. The sale will transform Symantec into a pure-play security vendor. Approximately $2.5 billion of the sale proceeds is planned to be returned to shareholders through share buybacks and dividends. The balance is aimed at acquisitions and R&D to booster growth in SYMC's core businesses of threat protection, information protection, and cyber security services.

This new-found focus and capital should launch a new growth phase for SYMC.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets.

The takeover offer to acquire Coffey International for $77 million is a good fit and should bolster TTEK's growth in the next few years. Coffey's international development division will help TTEK implement the numerous overseas contracts

Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Hersha Hospitality Trust	HT	NYSE	$ 21.76	5.15%	$ 28.42	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	$ 17.90	3.35%	$ 19.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	$ 28.58	1.54%	$ 34.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	$ 89.34	3.92%	$ 110.00	BUY
Alcoa	AA	NYSE	$ 9.87	1.22%	$ 10.50	BUY
Disney	DIS	NYSE	$ 105.08	1.26%	$ 118.00	BUY
Ford Motor Company	F	NYSE	$ 14.09	3.55%	$ 17.00	BUY
Freeport-McMoRan	FCX	NYSE	$ 6.77	2.95%	$ 14.00	BUY
NCR Corp	NCR	NYSE	$ 24.46	0.00%	$ 30.00	BUY
Pfizer	PFE	NYSE	$ 32.28	3.47%	$ 36.00	BUY
Stryker Corp.	SYK	NYSE	$ 92.94	1.14%	$ 105.00	BUY
Tetra Tech	TTEK	NASDAQ	$ 26.02	1.23%	$ 27.00	BUY
Third Avenue Small-Cap Value Fund	TVSVX	800-443-1021	$ 18.60	0.00%	$ 24.00	BUY
Xerox	XRX	NYSE	$ 10.63	2.35%	$ 11.00	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	$ 4.50	0.00%	$ 10.00	BUY
Chevron	CVX	NYSE	$ 89.96	4.76%	$ 100.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	$ 20.06	1.65%	$ 30.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	$ 10.91	0.82%	$ 14.00	BUY
Transocean	RIG	NYSE	$ 12.38	0.00%	$ 19.00	BUY
Valero	VLO	NYSE	$ 70.71	2.83%	$ 75.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	$ 18.44	0.00%	$ 19.50	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	$ 27.98	0.00%	$ 34.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	$ 24.73	0.00%	$ 26.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	$ 44.07	0.00%	$ 47.00	BUY
S&P 500 ProShares Ultra Short ETF	SDS	NYSE	$ 19.93	0.00%	$ 22.00	BUY
Symantec	SYMC	NASDAQ	$ 21.00	2.86%	$ 23.00	BUY
Tekla Life Sciences Fund	HQL	NYSE	$ 23.64	0.00%	$ 28.00	BUY

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

Notes to the table:
Prices are as of 12/31/2015. See our website for live pricing and buy limits:
http://www.soundadvice-newsletter.com/members
Yields on funds may include capital gain distributions.

awarded to it in 2015. Coffey's Geoservices division can take over TTEK's low-margin work in this area. Most importantly, Coffey will give TTEK an entry into Australia to expand its strongest area, water engineering services.

Xerox (XRX) is continuing to transform from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenue. These outsourcing arrangements are long term in nature and encompass a wide range of profitable services for larger customers and result in contract renewals of close to 90 percent.

We have been emphasizing that XRX is very cheap relative to the rest of the market, and a good value. Evidently, Carl Icahn agrees. On November 23, it was announced that he purchased 72 million XRX shares for $86.5 million, close to 7 percent of the outstanding shares. In December, he bought another 10 million shares. Icahn typically buys undervalued stock in companies where there is something to fix in order to unlock value. He will likely start with upper management who have been comfortably paid despite poor performance.

He also likes to spin-off non-core assets and put the capital to better use. Icahn also likes to separate business segments to improve management efficiency and focus. These actions are bound to be positive for both the near term and long term prospects.

Capital Competition: Real Estate versus Stocks: The SoundAdvice Risk Indicator

There are few forces that are more important to a market's destiny than the amount of capital that is available to it. In a normal situation, capital will flow easily between markets as their underlying conditions change. But if a market becomes dangerously superheated, it will absorb a larger proportion of available investment capital than economic conditions and market demand can justify. This change will be reflected not only in the rising market's prices but also in the prices of competing markets, which will be lower than their underlying fundamentals would indicate they should be. Over the last 100+ years, we can see this titanic struggle between the stock market and its foremost competitor for investment dollars: real estate.

To reveal this phenomenon, we have set up an equation in which we divide the Standard and Poor's 500 Stock Index average by the median price of a new house for each month over the last 100+ years. This equation exhibits an elegant financial minuet as each market has taken turns outperforming the other.

As we look at the historical data, we find that there is a range in which the price disparities are so strong that they are too great to be accounted for by the fundamental economic conditions underlying each market. Every time prices get into these danger zones it has meant that the prices in one market or the other have gone too high, and that they are in imminent danger of falling.

We can, therefore, label this new tool the SoundAdvice "Risk Indicator," since it will allow us to locate the point at which prices are so high when compared to competing markets that they have come loose from their moorings and are on the verge of declining or underperforming the other market.

What is too high? When stock prices are very high relative to house prices, the SoundAdvice Risk Indicator will rise over the line marked 2.0, revealing a high-risk time for stocks. In contrast, when the indicator drops below the line marked 1.0, it means that it is a very low-risk time to buy stocks. Notice from the chart how the SoundAdvice Risk Indicator has oscillated back and forth, revealing the ongoing struggle between Stocks and houses for investment capital. We have labeled these long vacillations Supercycles.

The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a $25,000 investment would have grown to $12.2 million in stocks and to $1.53 million in houses.

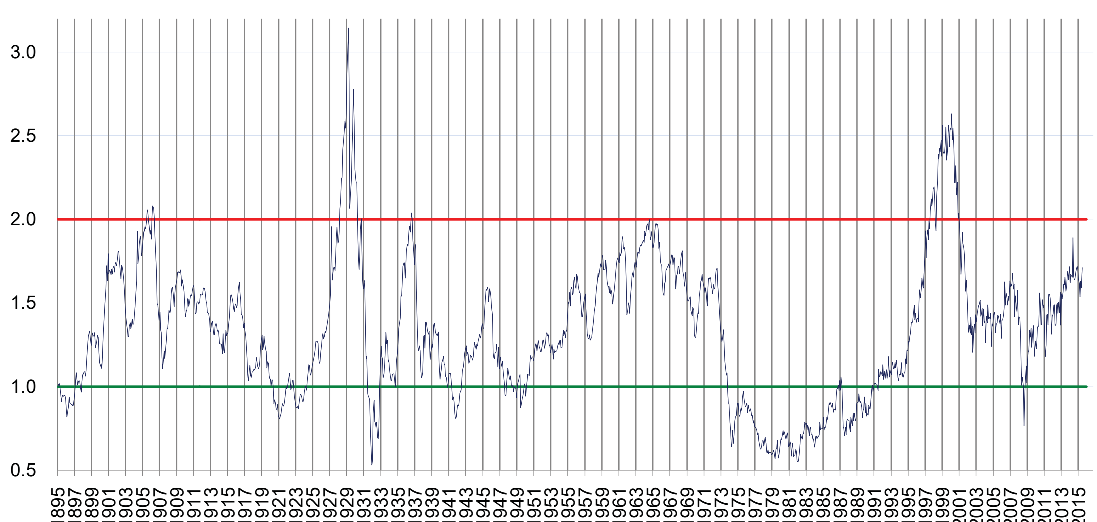
But though an investment beginning with $25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made $486 million, or 39.7 times more money—the difference between profits the buy-and-hold stock market strategy would have yielded by itself and the profits that the SoundAdvice Risk Indicator would have provided.

These figures illustrate why it is so important to remain aware of the Supercycles that are at work within markets.

The SoundAdvice Risk Indicator

The latest reading for the SoundAdvice Risk Indicator is 1.71. This reading reveals that stock prices are above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See ***The Science of Making Money in Turbulent Markets*** for a complete explanation of the SoundAdvice Risk Indicator and its track record. (You received a copy of this book with your subscription, and you will also receive an updated copy when you renew your subscription.)



Business Cycles and Stocks:
The SoundAdvice Diffusion Indexes

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

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

To construct our SoundAdvice Diffusion Indexes, we observe changes in each of our selected indicators over a six-month period. For every indicator that is unchanged from its value during the six-month span, we will attach a value of one half point (0.5). If an indicator falls below its level six months prior, it will be given a value of zero. If an indicator is higher than it was six months before, it is assigned a value of 1.0. The sum of all of these figures will be expressed as a percentage of the total number of indicators. If, for example, one indicator is up (+1) at the end of a six-month period, one is unchanged (+0.5), and one is down (0), the diffusion index will be (1.5)/3 or 50 percent.

When the SoundAdvice **Diffusion Index of Leading** Indicators drops to zero, it is time to buy stocks aggressively, regardless of how negative the atmosphere may be. This is not just an empirical coincidence. It is also logical. In order for all of the leading economic indicators to be giving off a zero value compared to six months before, it is nearly certain that the soft economy is providing an atmosphere for stable or declining interest rates.

This Diffusion Index gave us a zero reading in March, 2015.

The previous zero reading was in April, 2009, close to the bottom, officially giving us an "Aggressive" signal. That signal came at a time when the Risk Indicator was below 1.0, which revealed that Supercycle 5 came to an end, and that Supercycle 6 was born.

However, the March 2015 signal was usurped.

The SoundAdvice Diffusion Index of Lagging Indicators gives "Caution" signals when all three of its individual lagging economic indicators rise above their respective levels of six months earlier, providing a 100 percent reading which reveals that the economy is about to put upward pressures on interest rates.

This has been a critical indicator in the past and has aided in avoiding severe declines, most notably the crash of 2008-09. However, since then, the Federal Reserve's Quantitative easing program has been holding short-term rates artificially low to stimulate the economy.

This index hit 100% in 2012. Although we operated under the "Caution" signal, we have continued to be bullish about stocks because of the Federal Reserve's expansive monetary policy and its quantitative easing program, which has been distorting the natural business cycle.

The lagging economic indicators released in June, 2015, (for May) caused the SoundAdvice Diffusion Index of Lagging indicators to hit 100 percent, giving us a new caution signal.

Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 32 percent. During "Caution" signals, the S&P 500 increased an average of 2.3 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Mar-15	2,080.0	May-15	2,111.9
Ave +/-	32.0%		2.3%

See ***The Science of Making Money in Turbulent Markets*** for a complete explanation of the **Sound**Advice Diffusion Indexes and their track record. (You received a copy of this book with your paid subscription, and you will also receive an updated copy when you renew your subscription.)

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