

The Treasury Bond Paradox



The *Sound Advice* Portfolio is up 7.6 percent since the beginning of 2015, as compared to 2.4 percent for the S&P 500.

We have an average profit of 66 percent in the *Sound Advice* portfolio, based on the prices that each position was recommended.

-- Gray Emerson Cardiff

There have been some interesting cross-currents acting on the Treasury bond market. Just recently, long-term Treasury bond yields broke out of their 6-month trading ranges to the upside, even after the dovish comments following the Federal Reserve meeting in the final days of April. The rise is significant. Evidently, the market is anticipating something that the Federal Reserve is not.

As part of the Federal Reserve's economic projections, each member of the Federal Open Market Committee (FOMC) 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 Latest Dot Plot

The most recent Dot Plot predicts that the Federal funds rate will be 0.625% at the end of 2015, up from zero currently. The Federal funds rate is predicted to be 1.875% at the end of 2016, and 3.125% by the end of 2017. Over the longer run, the consensus ranges between 3.25% and 4.25%.

This latest Dot Plot scenario is lower than December's Dot Plot. It was compiled at the end of the very soft first quarter. A number of factors were undermining the economy, including weather, an extended port strike, and the strong dollar. In addition, the first quarter is traditionally the weakest quarter of the year. Undoubtedly, also influencing the forecast was the current low interest rates in Europe, where a massive quantitative easing (QE) program has been instituted.

So Why Are Bond Yields Rising?

One of the strongest headwinds against rising bond yields has been the ultra-low bond yields in Europe and the unusually large spread between US bond yields and comparable yields abroad. However, as the European QE program has begun to get traction, European economies are showing life. The threat of deflation is waning and being replaced by expectations of a recovery. As a result of this shift in expectations, the dollar has declined substantially against the euro, by 25+ percent in recent weeks. The decline in the dollar against the euro has caused a 25+ percent capital loss on US bonds for European investors. This loss wipes out close to 10 years of the annual yield. As currencies fluctuate, an investment in US bonds becomes more speculative for foreigners, and thus, less attractive.

So, currency fluctuations introduce a paradox.

Until recently, long term Treasury bond prices have been rising (pushing yields lower), along with a strengthening dollar. This was under the specter of increases in interest rates at some point this year, as the Federal Reserve was proposing to start the process of normalizing monetary policy. This inverse movement occurred because higher US interest rates attracted foreign capital into dollar-denominated US Treasury bonds. The influx caused the dollar to strengthen and pushed bond prices up and yields down.

However, this process has now reversed. Recent assurances from the Federal Reserve that it will not raise interest rates anytime soon, along with the growing general perception that the first hike will be further out, has caused the dollar to weaken, causing currency losses for foreign bond-buyers. The losses have introduced a higher degree of risk for US bonds for foreign capital, which has caused yields to rise.

Thus the paradox: the perception of rising short-term interest rates was causing long-term bond yields to drop. Now the reverse is occurring -- the prospect of low interest rates persisting is causing bond yields to rise.

Now the question becomes: Will this paradox reverse and cause bond yields to drop again? The answer is no, or at least not nearly to the same extent.

A reversal could be sparked by the unlikely event that the Federal Reserve were to suddenly announce that it is going to start raising interest rates soon. That would likely strengthen the dollar. However, the recent weakness in the dollar has burned foreign bond holders. It has been a wake-up call that currency fluctuations add considerable risk to US Treasuries for foreign holders. It is not likely that they will jumping into US Treasuries again to the same extent.

It is more likely that the Federal Reserve will wait to begin raising US interest rates until it sees further strength in the US economy. An additional factor would be more improvement in the Euro zone. Just as our QE program kick-started the US economy, Europe's QE program is bound to have the same impact there. China and Japan also have aggressive expansionary monetary programs that are certain to have the same impact.

Once foreign economies show sustainable strength and get more in sync with the US, foreign interest rates will rise. If the Federal Reserve does not begin increasing interest rates here, the dollar will get even weaker, and the paradox will continue in the current direction. If on the other hand, the Federal Reserve starts increasing US interest rates, interest rates around the world will be rising more or less in unison, causing currency fluctuations to diminish. As a result, the paradox (which stems from currency fluctuations) will fade. Even a reversal, due to uneven increases in interest rates, will be much less powerful.

Commodity Inflation?

Another game-changer will be US inflation. Looking backwards, inflation has been undermined by falling commodity prices. However, the downward trend in commodity prices has changed. The most obvious is the reversal of oil prices. What is not so obvious is the CRB index which reflects the prices of other basic commodities. There has been a significant upturn in this index during recent weeks. The index has just crossed its 20-week moving average, which is a reliable indicator that a change in the trend has occurred.

The "No-Brainer" ETFs

We are recommending three ETFs designed to benefit from the inevitable rise in long-term Treasury bond yields. These ETFs differ in the amount of leverage used:

The [Direxion Daily 20 Plus Year Bear 3 Shares \(TMV\)](#) uses 3:1 leverage.

The [Proshares Ultrashort Lehman 20 Plus Year Treasury \(TBT\)](#) uses 2:1 leverage.

The [Proshares Short 20 Plus Year Treasury \(TBF\)](#) uses no leverage.

You can choose one or all of these ETFs, depending on your investment objectives and risk tolerance. We have dubbed these ETFs as "No-Brainers" because interest rates and bond yields always rise during an economic recovery. The ascent has never been smooth and this time has proved to be no exception.

The price action of these ETFs is based on the changes in long-term treasury bonds, specifically BlackRock's iShares 20+ Year Treasury Bond ETF (symbol TLT) which holds a portfolio exclusively of long-term Treasury bonds with an average maturity length of close to 27 years. The prices of our No-Brainer ETFs fluctuate in accordance with the daily fluctuations of TLT, only in the opposite direction, multiplied by the leverage each uses. For example, a decline of say, 1.0 percent in TLT will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in TLT will cause these ETFs to drop in the same fashion. We can project the movements of these ETFs based on any given scenario.

Assuming Treasury bond yields move in tandem with the Federal Funds rate, here is what would happen to each ETF under the latest Dot Plot scenario:

TMV would rise to \$42 by the end of 2015, to \$78 by the end of 2016, and to \$135 by the end of 2017.

TBT would rise to \$57 by the end of 2015, to \$86 by the end of 2016, and to \$124 by the end of 2017.

TBF would rise to \$28 by the end of 2015, to \$34 by the end of 2016, and to \$41 by the end of 2017.

The latest Dot Plot forecast is likely to be low. As noted earlier, it was taken at the end of a very soft first quarter. In addition, the Treasury bond paradox was not likely to be built into expectations at the end of the first quarter, while the dollar was still strong.

At some point in the not-to-distant future, as Europe's QE program, along with ultra-easy monetary policies around the world, stimulate economic growth, interest rates will rise globally, and cause bond yields to increase substantially.

More Energy for Your Portfolio

The crash in oil prices has caused a wide-spread drop in the energy sector and every stock within it without exception. As the market as a whole climbs to historically higher valuations, the energy sector is one of the few sectors presenting values that are historically low.

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The last issue of *Sound Advice* gave the big picture of the oil and gas industry. In summary, we noted that with oil prices down 50 percent from their peak since mid-2014, it is easy to forget that the US still imports 45 percent of its needs, even with US oil wells pumping at peak production levels. The US is still highly dependent on other sources of oil – whether from the Middle-East or from deep water wells on ocean floors.

During the 2008-09 melt-down, the price of oil fell from an all-time high of \$145 a barrel to under \$40, and domestic oil rigs in use dropped by 50 percent. This time, as the price of oil started crashing, the domestic oil rig count peaked in October of last year at 1609, and has again plummeted 50 percent.

However, there is a lag time from a peak in drilling rigs and a peak in production. This is because it typically takes 3 to 6 months for a new well to begin producing from fracked shale. A new oil well spews many hundreds, or even thousands of barrels per day before its production levels off after a year or so, to 20 percent of the initial production. Many of the new wells drilled from the tail end of the high rig counts in October, as well as those drilled since then, are still spewing their initially-high production volumes.

However, we know from the sharp decline in domestic rig counts that the number of new wells has fallen correspondingly. We also know that the new wells drilled after the October peak in rig counts are close to experiencing the typical steep production decays, if they haven't already. This means US oil production will be declining soon.

We could be there right now. Domestic production has stopped increasing in recent weeks, a marked change from the constant booming increases of recent years. The price of oil has climbed significantly during the last two months. It has become clear that we have already seen the bottom.

The Context

Last year at this time, with oil in the vicinity of \$100, there were 397.7 million barrels of oil in US storage tanks. Today's 489 million barrels is 91.3 million barrels more, which quantifies the glut that pushed the price of oil down more than 50 percent.

Even just a 10 percent reduction in today's production of 9.4 million barrels per day is 6.6 million barrels per week, which equals 14 weeks of the 91.3 million barrel glut.

Here is another way to look at it. Even at today's peak US production of 9.4 million barrels a day, the US still imports 7.8 million barrels per day. The 91.3 million barrel glut is less than 12 days of our imported oil needs.

As one of the few deeply discounted values left in the market, carefully chosen energy stocks are bound to enhance the long-term performance of our portfolio.

Chevron (CVX)

In our mid-month April update, we expanded our energy holdings by adding Chevron (CVX) to the portfolio.

Besides being a major international oil company, CVX is a vertically integrated oil company, which means it has operations in all phases, from exploring and drilling for oil, to transporting and refining, and even to retail sales at its gas stations. Profits from these various stages of production will change with the price of oil. When oil prices are high, margins are high from drilling, while margins are low from refining. However, the reverse is also true.

With oil prices crashing during the last half of 2014, CVX's drilling and productions profits declined 18 percent. However, profits from refining nearly doubled. Unlike independent refiners, integrated oil companies can add value to their refining operations.

On May 1, CVX reported first quarter earnings of \$1.37 per share, which were far ahead of the expectation of 79 cents. Of course, oil revenue was way down, along with drastically lower prices, but revenues from refining more than doubled, confirming the benefit of being an integrated oil company.

The dividend is currently \$4.28 per share. The depressed price of the stock puts the yield close to 4 percent. This yield does not happen often. The last time was during and shortly after the 2008-09 melt-down.

This is a historically high yield for CVX. The dividend has increased annually for 27 consecutive years, and the company undoubtedly wants to keep that string intact. Management appears to be making room for an increase by trimming its 2015 capital spending budget by 13 percent, suspending its share buy-back program of \$1.25 billion per quarter, and selling assets. Whether the dividend increases this year remains to be seen, but the long-term trend is for annual increases.

Growth Prospects

In recent years, CVX has led its peers for return on capital. However, that was when oil prices were rising. Without a robust oil market, CVX will need to see growth in its volume of production. That will be coming from the Gulf of Mexico, West Africa, Western Australia, and the Gulf of Thailand.

Chevron has skills and expertise in deep-water exploration beyond its peers, which makes the company a valuable partner in world-wide deep water production sharing opportunities.

The Natural Gas Connection

Natural gas will also be a growth engine. Natural gas is poised to see the greatest growth in market share of all fuel types in the years ahead. As we point out regularly in these pages, a substantial disparity still exists between the energy equivalent costs of oil and natural gas, which translates into an expanding natural gas industry.

Natural gas can be compressed and chilled to -260F into

liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia, where demand and prices are much higher. In Europe the price of natural gas is three times higher than in the US. Prices are close to four times higher in Asia.

Chevron is using its financial might to expand its LNG deep-water infrastructure for its offshore natural gas reservoirs. There are two LNG projects underway in Australia. The one in Gorgon is scheduled to start up this year and has the capacity to ramp up to the equivalent of 200,000 barrels of oil per day. The Gorgon Project is developing the Gorgon and Jansz-Lo gas fields, located within the Greater Gorgon area, between 130 and 220 kilometers off the northwest coast of Western Australia.

The Gorgon Project is a joint venture between the Australian subsidiaries of Chevron (47.3 percent), ExxonMobil (25 percent), Shell (25 percent), and other miner partners.

Wheatstone is the other Australian facility with a similar capacity. Nine production wells have been drilled to the top of the gas reservoir, and production is scheduled to begin in 2016. Wheatstone includes an onshore facility with a domestic gas plant and two LNG trains for transportation. Close to 85 percent of the production from Chevron's equity has been committed to premier LNG buyers.

LNG facilities like these have long production curves and require very little in the way of capital expenditures to keep up production. The free cash flow from these facilities is projected to be substantial and even support investment elsewhere to bolster growth.

Adding CVX at the current price is bound to enhance our portfolio performance over both the short term and long term.

Here are Updates on the rest of our energy portfolio.

Chesapeake Energy (CHK) is the nation's second largest producer of natural gas next to Exxon Mobil.

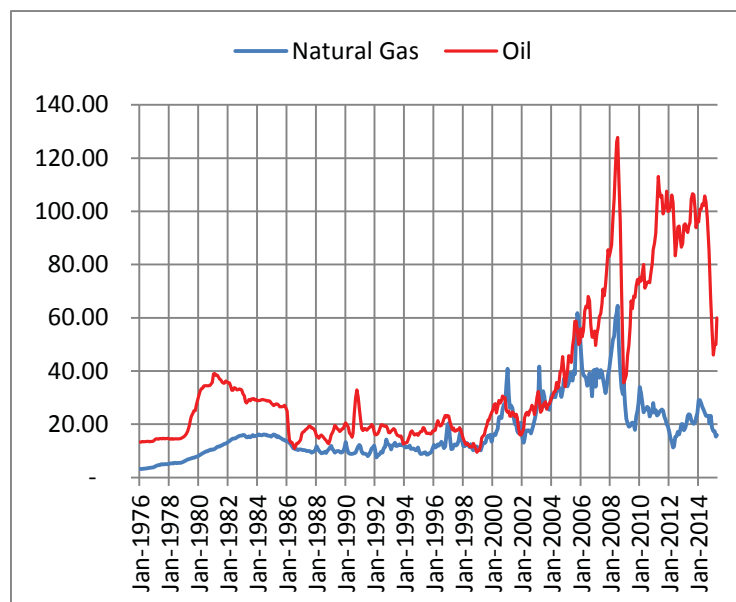
CHK is still close to its low-point reached at the bottom of the 2008-09 crash. However, it is a much more solid company than it was then with free-spending chairman and CEO Aubrey McClendon at the helm. CEO Doug Lawler, an accomplished ex-Anadarko executive, has reduced overall expenses substantially.

Even with natural gas and oil prices in their current vicinities, CHK should have a positive cash flow in the neighborhood of \$3 billion in 2015 and again in 2016. CHK has adequate cash reserves for its reduced capital spending budget.

Morningstar's fair value estimate for Chesapeake is \$27 per share, nearly double the current price of CHK. In late March, for the first time in 2 years, Carl Icahn raised his stake in CHK. He now holds more than 13 million shares which is close to 11 percent of the company.

Fidelity Select Natural Gas Fund (FSNGX) is a diversified way to participate in the recovery of the natural

The Cost of Energy Equivalents of Oil and Natural Gas



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 growth outlook is bolstered by new facilities coming on line to transport US natural gas to the rest of the world. On the Louisiana coast, the largest super-cooling facility for natural gas (the Sabine Pass liquefaction terminal) is scheduled to be completed later this year, and will chill natural gas to -260F into liquefied natural gas (LNG) so it can be loaded onto tankers and sold to customers in Europe and Asia. This will be the first facility to export LNG from the contiguous US. Two more such facilities are scheduled for completion in 2018.

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 \$60 a barrel, that is the cost of 5.8 million BTUs. However, with a market price for natural gas close to \$2.75 for one million BTUs, 5.8 million BTUs will cost \$15.95 (5.8x\$2.75). So the same amount of energy is available for 27 cents on the dollar, if it is in the form of natural gas rather than oil.

The chart above shows 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 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 moved closer together when the price of oil dropped, 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.

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

The fund has not suffered nearly as much as the drop in the price of oil. It declined 5 percent in 2014 but is up by that much this year, all during a 50 percent in the price of oil.

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

Transocean (RIG) has been hammered by the sharp drop in oil prices. In February, RIG cut its dividend to 60 cents per share, which was not a surprise in view of the oil price crash. The current 60 cent dividend, which is not likely to be lowered again, is a solid 3.5+ percent yield. This puts a floor in the vicinity of the current stock price because any substantial drop in the stock price from here would cause the yield to increase materially, which would be out of line with the industry.

The reduction in the dividend helps the long-term growth potential of the stock price from here because it strengthens the company's balance sheet. The approximate \$900 million in savings can go toward debt reduction and reinvestment in the company, both of which help to preserve the company's investment grade rating.

It is important to keep in mind that even at today's peak production, the US still imports nearly half of its oil needs. Deep water drilling is still a necessary source for US and the world's oil needs.

RIG has not been this low since the early 1990s. Long term profits should be stellar from here.

Portfolio Updates

Here are updates on the rest of the portfolio in alphabetical order.

Agrium (AGU) has a broad mix of agricultural products and services that increases the efficiency of food production. AGU products will be in growing demand as arable land continues to disappear around the world while worldwide population and per-capita income increases.

Agrium derives close to half of its revenue as the largest agricultural retail operator in the US from its 750 retail farm stores, offering seeds, fertilizers, and other crop chemicals directly to farmers. The retail network stretches across the country which allows collection of important weather, soil, and pest information that is used to gauge buying patterns. Agrium is continuing to add retail centers, which are an important source of growth and gives the company bargaining power with suppliers.

Agrium estimates 2015 earnings to be in the range of

\$7.00-\$8.50 per share, for a median of \$7.75. The annual dividend recently increased to \$3.12 per share. AGU is trading at a price/earnings (P/E) ratio below the P/E for the S&P 500.

Associated Estates Realty Corp (AEC) is leaving the portfolio after giving us a nice gain of 106 percent, counting dividends.

On April 22, the proxy battle came to a head with a \$28.75 a share cash takeover bid for AEC from Brookfield Asset Management. The stock jumped \$4.01 to \$28.49 per share on the day after the announcement.

It often takes an activist to wake up the market, and bring attention to the sleeping bargain. We had a similar experience with Commonwealth REIT, which we recommended when it was selling for a deep discount, and a proxy battle threw out the old management and unlocked the value.

In 2011, we originally recommended AEC at \$15.40 as an undervalued REIT, when the stock price was at a substantial discount to the equity of its underlying apartment properties. Evidently, the Land & Buildings Fund, led by Jonathan Litt, saw the value we did. After investing \$1.1 billion in AEC late last year, the Fund began pushing management to sell Associated Estates to unlock the value. When AEC management rebuffed the proposal, the Land & Buildings Fund launched a proxy battle.

You may have recently received proxy materials from both sides of the battle. We were going to advise voting in favor of all of the proposals offered on the Land and Building's ballot. However, the matter is now moot because the pressure of the proxy battle caused AEC management to relent and sell the company to Brookfield. The May 22 shareholder meeting with the proxy vote has been canceled.

The purchase price of \$28.75 translates to a 5.67 percent capitalization rate which means the stock price is no longer at a significant discount to the value of its net assets. With the market price of AEC currently close to Brookfield's bid price, we do not see much upside left, and there is always a chance the purchase may not go through.

Our April 23 e-mail update advised selling. The price has not changed since then, so if you have not already done so, we recommend selling AEC now.

Boston Scientific (BSX) has medical products that are well suited for an aging population in the US. The company's mission is to transform lives through innovative medical solutions that improve the health of patients around the world. BSX has been a global medical technology leader for three decades by providing a range of high performance solutions aimed at addressing medical needs and reducing healthcare costs. BSX ended 2014 with 943 US patents.

The more significant recent approvals are in the cardiac care arena. One is called the Watchman Heart Device, which is implanted on the left atrial appendage of the heart and helps prevent blood clots from atrial fibrillation. It is the first of its kind to serve as an alternative to blood thinners for stroke prevention. Another one of BSX's recent approvals was for its

Subcutaneous Implantable Defibrillator, which is implanted under the skin to provide protection against sudden cardiac arrest.

In an effort to promote growth, BSX is promoting alliances and presence in China. BSX is forming a partnership with the Chinese surgical stapler maker, Frankenman Medical Equipment Company. The two companies plan to work together to develop and manufacture products in China, one of the world's largest and fastest-growing medical device markets.

Ford (F) is close to 10 times 2014 earnings which were depressed because of down time and preparation for 24 new or refreshed vehicles, including the all-aluminum F-150 truck which is likely to set a new industry standard. It weighs 700 pounds less and is projected to get close to 30 miles to the gallon. Growth prospects in 2015 look good.

In April, the National Highway Traffic Safety Administration awarded the 2015 F-150 SuperCrew with its top five-star rating. The F-150 is Ford's best-selling vehicle in the US, and is the company's most profitable product.

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.

China was Ford's second most profitable market in 2014 behind the US. With sales of 22 percent of its cars, Ford was only four percent of China's market share. Ford expects China alone to generate 40% of total sales by 2020.

Sales in China have been limited by Ford's ability to produce cars. However, in November, Ford opened its assembly plant in Chongqing, which enables the production of 360,000 more cars in 2015. Another plant is scheduled to come online in Hangzhou in 2016 to produce another 250,000 cars.

Freeport-McMoRan Copper & Gold (FCX) is the world's largest copper producer. Copper is woven into the fabric of the world's developed economies, and its price moves dramatically in tandem with expansions and contractions. We made a 643 percent gain during the last expansion, from March 2003 until December 2006, on Phelps Dodge, the largest copper producer back then. As the world's economies continued to expand into 2008, so did FCX.

Today's quantitative easing programs and expansive monetary programs around the world are bound to translate into expanding economies and increasing demand for copper. The stage is being set for another cyclical run in FCX.

FCX also suffered along with the general decline in energy stocks because of its 2013 acquisition of oil and gas assets in California, Texas, Louisiana, and the Gulf of Mexico. The company plans to continue developing these assets and may finance the project by spinning off these oil and gas properties through a public offering. If and when

this occurs, we will evaluate the proposition.

Hersha Hospitality (HT) is selling at a discount to its hotel assets which are sensitive to the business cycle and will benefit strongly from the US economic recovery. In addition, nearly a third of its major properties have been undergoing renovations and not producing their full income potential. HT saw the beginning of the benefits from completed renovations and new acquisitions during the third quarter of 2014. The first quarter showed continued improvement with 10.9 percent growth in revenue per available room (RevPAR). The growth came from strong same-store performance as well as from 2014 acquisitions and new renovation projects.

Based on the most recent four quarters, we estimate the value of HT to be \$6.95. We expect this value to increase as net operating income continues to increase as revenue increases from the 2014 acquisitions and renovations.

The Company repurchased approximately two million outstanding common shares for \$12.6 million during the first quarter at a weighted average cost of \$6.36 per share. The Company will continue to consider further repurchases during periods of share price volatility.

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. A catalyst for growth comes from the fact that a majority of ATMs in the US still run on Windows XP which Microsoft just stopped supporting. That will translate into increased demand for NCR's ATMs.

In 2013, NCR increased its debt load to make two significant purchases -- Retailix, a transaction software provider, and Digital Insight, an online and mobile-banking solution provider. The cost of the debt used for these acquisitions dampened earnings growth which caused the stock to slide to its current attractive level. These acquisitions pushed NCR much farther along its path from a hardware provider to more of a software and services provider where profit margins are substantially higher, and should be contributing to earnings substantially. Fourth quarter revenue reported in February was evidence that the acquisitions are beginning to prove beneficial.

In mid-April, NCR launched a significant software platform called Kalpana, which moves ATM software and operations to the cloud.

NCR is a value play. It is close to 10 times 2015 estimated earnings – a steep discount to the market. Its price to sales ratio is 0.8 compared to the industry average of 1.8. Its price to book value ratio is 2.7 compared to the industry average of 6.0.

Values like this often attract activists who make large investments and then try to unlock the value. There are some activists sniffing around NCR. JANA Partners recently purchased 7.1 percent of the outstanding shares. Marcato Capital Management, also an activist hedge fund, has also purchased a stake in NCR.

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. The most recent to receive approval was *Palbociclib*. Trade-named "Ibrance", treats one of the deadliest forms of breast cancer by inhibiting two enzymes that promote the growth of cancer cells. It is expected to be a blockbuster for PFE, producing \$4 billion in sales by 2020. In April, PFE announced a Phase 3 trial.

Pfizer's current top selling drugs include *Lyrica* (for pain and fibromyalgia).

PFE's *Prevenar* vaccines (for pneumonia and other infections) had a very strong quarter, particularly in the U.S. where revenues increased 80 percent following the recommendation from the US Center for Disease Control.

Eliquis is gaining significant momentum amongst cardiologists for non-valvular atrial fibrillation.

Xeljanz also made continued progress as a key product for rheumatoid arthritis.

In the first quarter earnings call, the company projected 2015 earnings to be \$1.95-\$2.05 per share. This puts the stock price close to 17 times earnings which is in line with the market as a whole.

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) is bound to continue to rise, along with the dividend, and push the price of this REIT upward.

The earnings report at the end of April confirmed this trend. FFO climbed 32.5 percent year-over-year. Due to an increase in the number of shares two quarters ago, FFO increased 9.5 percent per share, which was still above expectations. The first quarter's increase was an improvement over the fourth quarter, which indicates that the cash from the issuance of new shares is being put to constructive use. So far in 2015, ROIC has added \$207.2 million to its grocery-anchored retail centers.

ROIC pays an attractive dividend that lowers its risk profile.

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.

SYK reported first quarter earnings of \$1.11 per share, a 4.7% year-over-year increase, which was in line with expectations. US sales were up 8.5% year over year driven by higher demand for orthopedic products. The MedSurg division was also strong, up 8.1%, and the Neurotechnology division showed 10.4% growth. International sales were up 5.4% but the strong dollar translated into a decline of 7.4% year-over-year.

Earnings are now expected to be from \$4.95 to \$5.10 per share for 2015. Next quarter's earnings are expected to be from \$1.15 to \$1.20 per share. This puts the price of the stock close to 19 times earnings, slightly higher than the market as a whole.

Stryker's cash-rich balance sheet and strong cash flow gives SYK avenues for continued diversified growth through acquisitions. Recent acquisitions include Small Bone Innovations, Pivot Medical, Berchtold Holding, and MAKO Surgical acquisition, as well as Trauson Products, China's largest manufacturer of orthopedic implants.

Stryker recently announced it will be buying back \$2 billion of SYK in 2015, following the purchase of \$100 million in 2014.

Symantec (SYMC) SYMC is the dominant supplier of software for computer security and protection against viruses and other nuisances through its leading flagship brand, Norton. SYMC has 20,000 employees residing in 50 countries working on new solutions in growing markets including backup appliances, mobile, cloud, advanced threat protection, data loss prevention, and managed security services. Nearly all of the Fortune 500 companies are Symantec customers. If there ever was a more certain growth industry, protection from cyber espionage is it.

Cyber attacks against large corporations jumped by 40% over the past year according to Symantec's latest annual Internet Security Threat Report. The report paints an alarming picture of the sophisticated cyber criminal and the methods used to get malware into social media, website cookies, and shady downloads. Large volume social media users in particular, clicking and sharing, constantly accessing, distributing and responding to hyperlinks can spread viruses very quickly. Some malware is designed specifically to violate a large company's security system such as with Sony and Target's retail stores. Symantec says Malware threats have been detected in more than 157 countries.

By the end of this year, SYMC will spin off its relatively small storage business which will allow both companies to be more competitive and responsive to their respective industries. The spin-off will make the balance of SYMC a more attractive acquisition to large I.T. companies with its strong balance sheet, along with its good cash flow and margins.

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.

Tetra Tech (TTEK) is a leading company in water technologies and environmental remediation with a healthy balance sheet including \$500 million of capital for growth in strategic markets. TTEK has a backlog of approximately \$1.87 billion in signed contracts to clean up military bases across the US. TTEK recently announced a two-year, \$200 million share repurchase program which will enhance earnings.

At the end of April, TTEK reported strong earnings of 31 cents per share. The stock jumped 11 percent the next day. The company also announced the acquisition of the Cornerstone Environmental Group, an environmental engineering firm in Middletown, NY.

Third Avenue Value Funds have a similar approach to ours because management is very price conscious, especially in relation to net asset value, in making decisions on whether to buy, hold, or sell a particular company. 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. Specifically, the management team looks for 4 fundamental characteristics before making investments:

- 1) The issuer has an especially strong financial position.
- 2) The common stock is selling at a price that reflects at least a 20% discount from Net Asset Value ("NAV").
- 3) There is comprehensive disclosure including reliable audited financial statements.
- 4) The prospects are that over the next three to seven years, NAV will be increasing by at least 10 percent annually (including dividends).

An additional similarity to *Sound Advice* is that members of management eat their own cooking – they invest a substantial amount of their personal assets into their recommendations by investing into the funds they manage.

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

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.

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 compound 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.

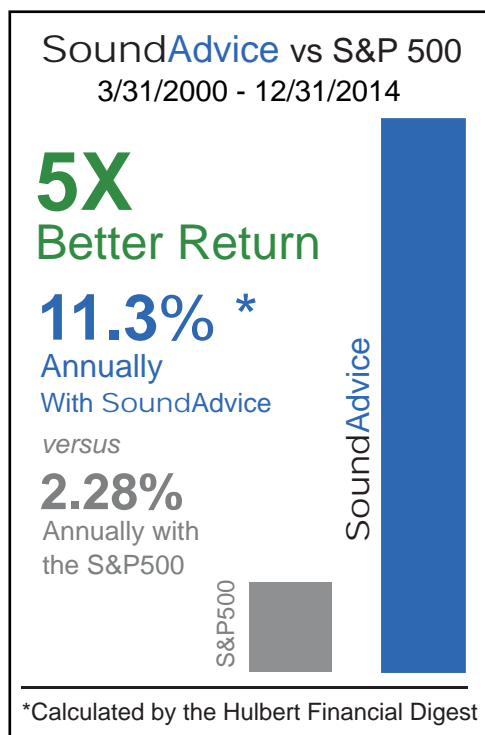
Small-cap stocks perform better than large-cap stocks over the longer term because they are pure plays on the early stages of new industries and inventions. They have more dynamic and entrepreneurial management, and they are much more likely to be the target of an acquisition or merger which is usually profitable. Not only do small caps perform better over the long run,

they generally benefit strongly from a recovering economy.

Vanguard REIT Index Investor Fund (VGSIX) is recommended because it reflects the REIT industry. It produced a return of 30.31 percent in 2014. As an alternative, the **Vanguard REIT ETF (VNQ)** can be used, which produced a slightly better return of 30.41 percent in 2014. The performances of both are substantially identical during the last 3, 5, and 10 years. VNQ trades like a stock and is purchased through your broker who will charge a commission.

VGSIX can be purchased directly from Vanguard (800-841-7999) with no fee, or through your broker who may charge a fee. If you are investing \$10,000 or more, the **Vanguard REIT Index Fund Admiral Shares (VGSLX)** is the same fund except with a lower expense ratio of 0.10 percent (versus 0.24 percent with VGSIX). VNQ also has the same low expense ratio of 0.10 percent.

The performance of all three choices should be above-average REIT performers because most funds do not perform better than the averages over the years, and REITs usually out-perform the market.



Income With Growth	Sym	Exchange	Price	Yield	Limit	Action
Associated Estates Realty Corp	AEC	NYSE	\$ 28.51	2.95%	\$ 25.00	SELL
Hersha Hospitality Trust	HT	NYSE	\$ 6.40	4.38%	\$ 7.80	BUY
Retail Opportunity Investment Corp	ROIC	NASDAQ	\$ 16.91	3.55%	\$ 18.00	BUY
Third Avenue Real Estate Value Investor	TVRVX	800-443-1021	\$ 32.44	1.36%	\$ 34.00	BUY
Vanguard REIT Index Fund	VGSIX	NYSE	\$ 26.57	1.35%	\$ 35.00	BUY
Diversified Growth						
Agrium	AGU	NYSE	\$ 104.32	2.99%	\$ 110.00	BUY
Ford Motor Company	F	NYSE	\$ 15.81	3.16%	\$ 18.00	BUY
Freeport-McMoRan	FCX	NYSE	\$ 23.66	0.85%	\$ 24.00	BUY
NCR Corp	NCR	NYSE	\$ 28.09	0.00%	\$ 35.00	BUY
Pfizer	PFE	NYSE	\$ 34.08	3.05%	\$ 36.00	BUY
Stryker Corp.	SYK	NYSE	\$ 93.40	1.13%	\$ 97.00	BUY
Tetra Tech	TTEK	NASDAQ	\$ 26.81	1.04%	\$ 26.00	HOLD
Third Avenue Small-Cap Value Investor Fund	TVSVX	800-443-1021	\$ 23.59	0.00%	\$ 27.00	BUY
Xerox	XRX	NYSE	\$ 11.52	2.17%	\$ 14.50	BUY
Energy/Natural Resources						
Chesapeake Energy Corp	CHK	NYSE	\$ 16.54	2.12%	\$ 19.00	BUY
Chevron	CVX	NYSE	\$ 109.04	3.93%	\$ 120.00	BUY
Fidelity Select Nat. Gas Fund	FSNGX	800-544-8888	\$ 35.15	0.94%	\$ 37.00	BUY
ICON Energy Fund Class S	ICENX	800-828-4881	\$ 15.30	0.59%	\$ 18.00	BUY
Transocean	RIG	NYSE	\$ 18.83	3.19%	\$ 20.00	BUY
Aggressive Growth						
Boston Scientific	BSX	NYSE	\$ 17.74	0.00%	\$ 19.00	BUY
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	NYSE	\$ 30.46	0.00%	\$ 35.00	BUY
ETF - ProShares Short 20+ Year Trsry	TBF	NYSE	\$ 25.12	0.00%	\$ 27.00	BUY
ETF - ProShares UltraShort 20+ Year Trsry	TBT	NYSE	\$ 45.87	0.00%	\$ 50.00	BUY
Symantec	SYMC	NASDAQ	\$ 25.14	2.39%	\$ 27.00	BUY
Teklka Life Sciences Fund	HQL	NYSE	\$ 26.80	0.00%	\$ 30.00	BUY

Notes to the table:

Prices are as of 4/30/2015. See our website for live pricing and buy limits:

<http://www.soundadvice-newsletter.com/members>

Yields on funds may include capital gain distributions.

Xerox (XRX) has been transforming from a seller of printers and copiers to a company providing business services in the form of business process outsourcing, information technology (IT) services, and document outsourcing (printing as a service). The strongest growth is coming from the expansion into IT services where services are performed under long-term contracts. Renewal rates have been generally high.

XRX delivered strong profit and cash flow in 2014 with encouraging growth throughout the year. Most importantly, revenue from services improved through the year along with improved margin performance. Document outsourcing revenues climbed over \$1 billion which included a multimillion-dollar contract late in the year with the Government of Canada.

However, the first quarter was disappointing, with earnings of \$0.21 per share, a year-over-year decline of 19%. As a result of the poor first quarter results, the company lowered its 2015 guidance by 5 cents to range from \$0.95 to \$1.01 per share.

The copier side of XRX met expectations during the quarter, but the services segment results fell short because of higher-than-expected startup costs for setting up some of the old legacy government health care accounts that did not have allowances for contingencies. Hopefully management will not continue to make these mistakes and they will not be recurring.

The recent dip in the stock price puts it close to 11.5 times earnings, very cheap relative to the rest of the market.

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 \$12.4 million in stocks and to \$1.5 million in houses.

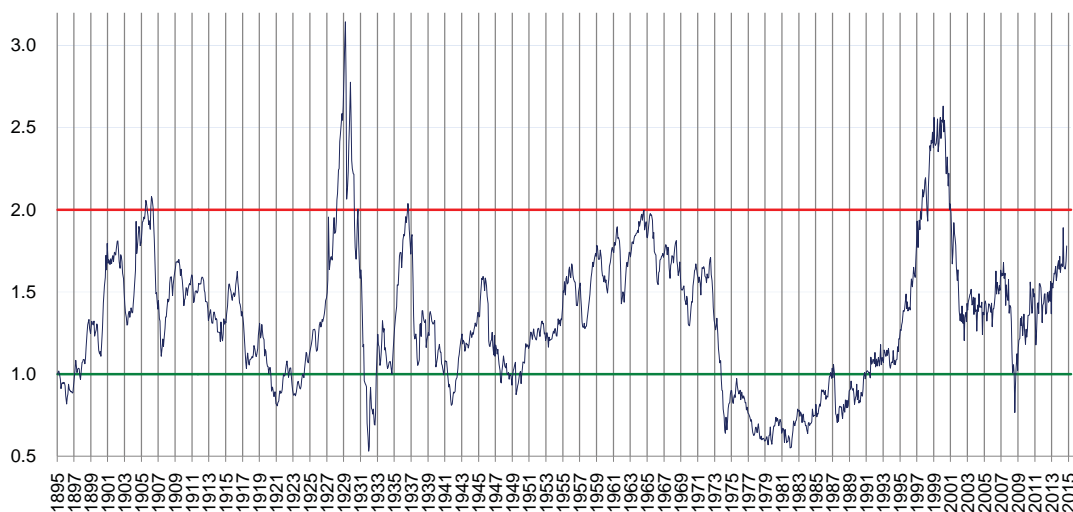
But though an investment beginning with \$25,000 in 1895 could have made money being in either stocks or housing and simply leaving it there over such a long period of time, had the investor followed the signals of the SoundAdvice Risk Indicator he would have made \$492 million, or 39.7 times more money—the 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 1.78. This reading reveals that stock prices are substantially above average in relation to house prices. The February 2009 reading of 0.77 marked the low for this cycle as well as the beginning of Supercycle 6.

See *The Science of Making Money in Turbulent Markets* for a complete explanation of the 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 economy as a whole must be very soft, which is the atmosphere necessary to produce a lasting decline in interest rates.

The SoundAdvice Diffusion Index of Leading Indicators: As far back as February and March 2009 we were projecting that our Diffusion Index of leading indicators soon would hit zero and mark an important buying opportunity. We made that projection by assuming that the leading indicators would not improve in the current economic environment. In fact that signal arrived in March, very close to the bottom, officially giving us an "Aggressive" signal. The market subsequently climbed 61 percent.

An "Aggressive" signal coming at a time when the Risk Indicator was below 1.0 revealed that Supercycle 5 came to an end, and that Supercycle 6 was born. Our next signal will come from a zero reading from our Diffusion Index of Leading Indicators. The latest reading is 0 percent.

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

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

This index hit 100% in 2012. Although we operated under the "Caution" signal, we earned a 25.74 percent investment return in 2013. We continued to be bullish about stocks because of the Federal Reserve's expansive monetary policy and its Quantitative Easing program which has been distorting the natural business cycle this time.

This index hit 100 percent for the fourth month in a row in June 2014 which told us that the economy has become strong enough to push up inflation and long-term interest rates along with bond yields. The latest reading was 66.7 percent.

Track Record of the SoundAdvice Diffusion Indexes

If we had followed the signals from our Diffusion Indexes over the years, we would have done very well indeed. The results are shown below. After each "Aggressive" signal, the S&P 500 climbed an average of 34.4 percent. During "Caution" signals, the S&P 500 increased an average of 2.9 percent.

Aggressive	S&P	Caution	S&P
Sep-74	68.1	Apr-76	101.9
Jul-76	104.2	Dec-76	104.7
Oct-78	100.6	Jun-79	101.7
Nov-79	100.0	Oct-83	167.7
Aug-84	164.5	Jun-85	188.9
Jul-86	240.2	Aug-87	329.4
Feb-88	258.1	Jun-88	270.7
Mar-89	280.0	Mar-93	449.7
Mar-95	493.2	Dec-98	1,141.0
Jun-00	1,429.4	Dec-00	1,320.3
Jun-03	974.5	May-05	1,191.5
Jun-06	1,276.7	Mar-08	1,325.4
Apr-09	848.2	Mar-12	1,370.3
Ave +/-	34.4%		2.9%

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

SoundAdvice
140 Town & Country Drive, Suite E
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