SoundAdvice

The Best Risk-Adjusted Returns in Both Up & Down Markets from 2000-2015 - Hulbert's Financial Digest

Advising Investors for 28 years | January 2017 Issue | January 1, 2017

Trumponomics in 2017: Good News/Bad News

The *Sound Advice* Portfolio was up 15.6 percent in 2016, as compared to 9.5 percent for the S&P 500. We have an average profit of 59.6 percent based on the prices at which each position was recommended.

-- Gray Emerson Cardiff, Editor

By the time you receive your next monthly issue of *Sound Advice*, Donald J. Trump will be the President of the United States. Our job as investors is not to be political, but to assess the ramifications to our holdings. It's like the old good news/bad news jokes. So far, the market has only heard the good news: corporate tax cuts, infrastructure spending, deregulation, and repatriation.

Tax Cuts

Reducing the corporate tax rate has the most obvious benefits. Not only will a tax cut reduce corporate expenses, it will lower the burden of paying dividends because they are not tax deductible.

The trailing twelve month earnings for the 2017 S&P 500 is $87.17, which puts the price/earnings (P/E) ratio at a lofty 25.7. However, the current estimate for 2017 is $132. That puts the overall market P/E ratio close to 17. To put this into context, the median P/E for the S&P 500 since 1870 is 14.6.

Michael Thompson, president and chairman of Standard & Poor's Investment Advisory Services, and his team evaluated the impact of Trump's tax cut proposal on the earnings for the S&P 500 companies. The conclusion was that every 1 percent decrease in the corporate tax rate would contribute $1.31 per share to S&P 500's annual earnings. Trump is proposing that the corporate tax rate be cut from 35 to 15 percent. Most companies do not pay at the highest tax bracket. The effective rate is close to 29 percent. The full benefit of a reduction from 29 to 15 percent would add $18.34 annually to the S&P 500 earnings. Annualizing that benefit for 2017 would bring the overall forward P/E down to 14.9.

Of course, Trump may not get his full reduction. Paul Ryan, the speaker of the House of Representatives, is talking about a reduction to 20 percent. The full benefit of a reduction to 20 percent would add $11.79 to the S&P earnings. Annualizing that benefit for 2017 would bring the overall forward P/E down to 15.6.

Of course, the tax code is complicated, and the entire tax cut may not make it to the bottom line of most companies. However, the benefits from a corporate tax reduction would clearly be significant.

Although harder to quantify, Trump's proposed reduction in personal taxes would stimulate growth which is bound to lead to additional increases in corporate earnings.

Infrastructure

Infrastructure spending, earmarked at $550 billion, is another pillar of Trumponomics. Because of lead times required for major construction projects, significant benefits are likely to be felt beyond 2017.

Deregulation

Potential benefits from deregulation have impacted bank and energy stocks the most since election-day. Banks are hoping to see some of the most stifling provisions repealed from the Dodd-Frank requirements installed after the 2008-09 melt-down.

Energy companies are looking forward to a relaxation of Environmental Protection Agency (EPA) regulations. During his first hundred days, President-elect Trump proposed that he "will lift the restrictions on the production of $50 trillion worth of job-producing American energy reserves, including shale, oil, natural gas and clean coal." Scott Pruitt is Trump's nominee to head the EPA, which will require Senate confirmation. He is Oklahoma's attorney general and has repeatedly sued the EPA over its rules and regulations. Carl Icahn, a staunch critic of the EPA, is also named as an advisor on regulatory overhaul.

Trump also proposes a reduction of the current tax rate on capital brought into the US by American companies. There would be a one-time repatriation tax of 10 percent on corporate profits brought into the US.

The Bad News

That's the good news. The bad news is that stronger economic growth stimulated by lower taxes, infrastructure spending, and relaxed regulation will boost inflationary pressures. Clearly, the era of slow economic growth, nearly zero inflation rates, and

historically low-interest rates is over.

Trade

Most economists agree that free trade is good for everyone, except for the most unskilled Americans who must be retrained, and that trade tariffs can be so detrimental to business conditions that they can actually end up increasing unemployment.

Right or wrong, Trump believes that America's workers are harmed when US companies move production outside the country to where labor is pennies on the dollar. This conviction is exemplified by Trump's recent intervention with Indiana's Carrier Corporation to stop the relocation of some 1100 jobs to Juarez, Mexico. Carrier's labor cost in Juarez is $6 an hour as opposed to $37 in Indiana, including associated costs and benefits. To deter US companies from moving jobs outside the US, Trump is threatening to impose 35 percent tariffs on products entering the US that have been manufactured for US companies outside the country.

Either way, whether moving production back to the US from cheaper foreign labor markets, or paying tariffs, will raise the cost of products. The components of most products sold in the US are produced elsewhere, so the end result will be directly inflationary.

Although Trump's rhetoric indicates otherwise, he is an advocate of free trade. However, he is not like unfair trade. In Trump's book, *The Art of the Deal*, he advises: "Use your leverage." The threat of tariffs is powerful leverage to renegotiate NAFTA and bring about better terms with China. Trump also has other leverage. Under the Trade Act of 1974, a president has the sole power to impose tariffs of up to 15 percent against countries with whom the US has a large trade balance deficit, without Congressional approval.

Trump also advises dealing from strength, which means upcoming negotiations are likely to be scary because an all-out trade war would result in serious economic damage to the major economies of the world, especially the US, China, and Mexico.

Timing

The last time we saw similar proposals was from President Reagan. His tax cuts took the form of the Tax Reform Act of 1981. However, this came at a recessionary time, with unemployment close to 8 percent, relatively high interest rates, and plenty of slack in the economy.

After 7 years of economic expansion thanks to the medication of historically low interest rates, today's unemployment rate is below 5 percent which is considered full employment. Most economists agree (and worry) that stimulating a fully-employed economy will be inflationary. The bond market agrees, as evidenced by the eruption of Treasury bond yields since election-day.

Conclusions

In addition to the upcoming inflationary forces from Trumponomics, we have confirmation from the **Sound**Advice **Diffusion Index of LAGGING Indicators** (page 11) which is telling us that the US economy is already strong enough to prompt a rise in inflation and interest rates. Accordingly, we are still operating with caution, and our portfolio selections reflect that caution.

ETFs for Rising Interest Rates

We have been 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 (down 14.3% in 2016).

The **Proshares UltraShort Lehman 20 Plus Year Treasury (TBT)** uses 2:1 leverage (down 7.4% in 2016).

The **Proshares Short 20 Plus Year Treasury (TBF)** uses no leverage (down 3.4% in 2016).

The price action of these ETFs is based on the changes in long-term treasury bonds, as measured by benchmark bond indexes, only in the opposite direction, and then multiplied by the leverage each ETF uses. For example, a decline of say, 1.0 percent in their respective benchmarks will cause TMV to increase by 3.0 percent, TBT by 2.0 percent, and TBF by 1.0 percent. Conversely, an increase in their respective benchmarks will cause these ETFs to drop in the same fashion.

We can project the movements of these ETFs based on any given scenario. We have been using the Federal Reserve's prediction, which was as good as any. As part of the Federal Reserve's quarterly Federal Open Market Committee (FOMC) meetings, each of the 17 committee members makes a prediction regarding the future path of interest rates. Those predictions are plotted in the so-called "Dot Plot".

The most recent Dot Plot was taken at the December meeting. As usual, there was a wide difference in the predictions among this group of informed experts. The median prediction was that the Federal funds rate would be 1.375 percent at the end 2017, 2.125 percent at the end of 2018, and 2.875 percent at the end of 2019.

It is worth noting that these are modest increases from the September meeting. The 2017 median increased by only 25 basis points (0.25 percent), the 2018 median by 30 basis points, and the 2019 median by 25 basis points. The Federal Reserve is data dependent. Members base their opinions on the most recent data available, and use older data for context. Accordingly, monetary policy is generally a reaction to recent and past conditions. This is why the Federal Reserve is usually "behind the curve" when major economic shifts take place, and this time appears to be no exception. The market, not the Federal Reserve, is raising interest rates, as evidenced by the recent rise in bond yields of both long and short in maturities. The Federal Reserve followed the market by increasing the Federal Funds rate target by 25 basis points in mid-December. With the Federal Reserve behind the curve, it is probable that the December Dot Plots will likely end up to be low.

However, in the spirit of being conservative, we can use the December Dot Plots as a basis of a forecast. Assuming long-term Treasury bond yields move in accordance with these target points (to preserve the same as today's real return), long-term Treasury bond yields would be yielding 3.94% by the end of 2017, and 4.69% by the end of 2018, and 5.44% by the end of 2019.

Here is what would happen to each ETF:

TMV would rise from $23.98 to $37.56 by the end of 2017, to $53.30 by the end of 2018, and to $73.43 by the end of 2019.

TBT would rise from $40.82 to $55.05 by the end of 2017, to $69.53 by the end of 2018, and to $86.09 by the end of 2019.

TBF would rise from $23.89 to $27.75 by the end of 2017, and to $31.18 by the end of 2018, and to $34.70 by the end of 2019.

The Erosion Factor

As pointed out regularly, these ETFs suffer from erosion because they decline slightly faster than they increase with an equivalent change in bond yields, particularly with higher leverage. To gauge this factor, we can assume that Treasury bond yields simply tread water, rising and falling by an unusually large amount, say, 0.04 percent (4 basis points) every day, and thus go nowhere for the next two years. Here is what would happen to each ETF:

TMV would decline to $22.26 by the end of 2017 (7.2%).

TBT would decline to $39.35 by the end of 2017 (3.6%).

TBF would decline to $23.61 by the end of 2017 (1.2%).

While not insignificant, this erosion factor is nominal in comparison to the price swings caused by a change in bond yields.

Energy/Natural Resource Selections

At the end of November, OPEC producers agreed to reduce output by 1.2 million barrels per day (bpd) beginning this month. In December, non-OPEC (NOPEC) producers agreed to cut output by 558,000 bpd: with Russia cutting production by 300,000 bpd, Mexico cutting 100,000 bpd, Azerbaijan by 35,000 bpd, Oman by 40,000 bpd, and Kazakhstan by 20,000 bpd. It is worth noting that most of the "NOPEC" cuts came from natural production declines which reduce the potential for cheating. Based on the forecast from the International Energy Association (IEA), these production reductions mean that production supplies should equal demand by mid-2017.

Although our energy stocks will benefit from a friendlier business climate, a larger benefit will come from a boost in demand for energy from a stronger US economy. Here are the merits of each of our recommendations.

Chesapeake Energy (CHK) gained 56% in 2016 and has a portfolio of 8 million net acres of oil and gas assets carried at a book value of $70 billion. CHK's debt load brought into question whether the company would survive the downturn. To reduce debt, CHK planned to sell $2 billion of non-core assets in 2016, and it ended up selling $2.5 billion. Debt maturing in 2017 has been reduced to $625 million from over $2.2 billion. Maturities in 2018 have been cut to $504 million from $1.0 billion, and 2019 maturities have been reduced to $599 million from $1.5 billion. The company has a $4 billion credit facility that it can tap until early 2019. CEO Doug Lawler says, "the company will continue to pursue opportunities to strengthen our balance sheet in 2017."

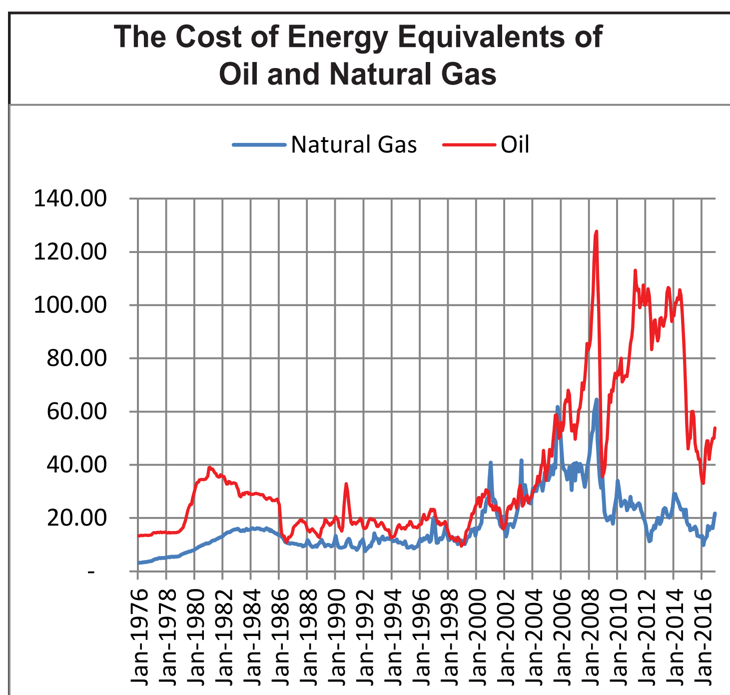
Drilling operations have commenced on a massive well in the Haynesville shale near Shreveport, LA, which the company believes could underpin CHK's financial recovery. The well is called "Prop-a-geddon" after the sand used to prop open hydraulically fracked shale to increase production flow. Due to economies of scale, this well could prove to produce for 75 percent less than typical costs. Prop-a-geddon went 2 miles deep and another 2 miles horizontally, double the standard distances.

Chevron (CVX) gained 35.6% in 2016 and is a vertically integrated oil company which means it has operations in all phases, from exploring and drilling (upstream), to transporting and refining (downstream). Profits vary from these 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. Management has pronounced the annual dividend as "sacrosanct" which provides an attractive yield and limits the downside risk.

Chevron has a huge proved reserve base of 11.2 billion barrels of oil equivalent to tap for growth. Two leading projects began production during the second half of 2016. The Bangka project in Indonesia began producing in August 2016, and the Alder project in the North Sea started in November 2016.

In December, Chevron announced its 2017 capital budget (capex) to be $19.8 billion. This is 15 percent lower than in 2016 and 40% lower than in 2015. This reduced capex budget reflects the company's focus on efficiency and production efforts in known and productive areas targeted to produce revenue within 2 years. The majority of capex is for further developing the two Australian LNG projects: Gorgon which started production in 2016, and Wheatstone which is scheduled to commence in mid-2017. The Tengiz field in Kazakhstan is another area of focus along with prolific domestic areas in the Permian Basin.

Fidelity Select Natural Gas Fund (FSNGX) gained 48.1% in 2016 and 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. One barrel of oil provides approximately 5.8 million British Thermal Units (BTUs) of energy. At, say $54 a barrel, that is the cost of 5.8 million BTUs. However, with the current market price for natural gas at $3.74 for one million BTUs, 5.8 million BTUs will cost $21.70. So the same



amount of energy is available for approximately 40 cents on the dollar, if it is in the form of natural gas rather than oil.

The updated chart 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. The fact that natural gas provides energy for pennies on the dollar will translate into an expanding natural gas industry.

A dividend of $0.124 per share was declared on 12/16/2016.

ICON Energy Fund Class S (ICENX) gained 24.9% in 2016 and 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 sector to capture value, rather than simply depending on rising oil prices. This fund is a good way to capture today's values and profit from the recovery and changing landscape on a diversified basis with professional management. A dividend of 0.05446 per share was declared on 12/20/2016.

Freeport-McMoRan (FCX) gained 94.8% in 2016 and is in our energy sector because it acquired substantial oil and gas assets at the top of the market in 2013 and took on close to $20 billion of debt to do so. The company has since been selling assets to reduce its debt burden. Through the third quarter, FCX had sold $6.6 billion in non-core assets.

In December, FCX concluded the sale of its deep water Gulf of Mexico properties to Anadarko Petroleum Corporation (APC) for $2 billion in cash. FCX also sold its onshore California oil and gas properties. These sales leave Freeport with oil and gas production onshore in South Louisiana and on the Gulf of Mexico shelf, along with oil production offshore California and natural gas production in Central Wyoming.

FCX is the world's largest copper producer. Copper prices typically rise during economic expansions because of the wide use of copper for new construction. Low copper prices in recent years have forced miners to cut back on exploration and development which has been reducing supplies. Projections from industry analysts call for shortages to begin appearing from as early as this year to the next few years. Two major sources of demand will determine the exact timing. Trump's infrastructure spending will be a large boost, and the amount and timing of the actual spending will play a significant role.

China is the world's largest copper importer and consumer, and has been exerting increasing demand in 2016 because the government has been stimulating the economy. Of course, a trade war with China would likely dampen its economic growth and its demand for Copper. Although in that event, China would likely increase its own infrastructure spending which could balance the demand for copper.

Transocean (RIG) gained 19.1% in 2016 and 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 because of its prospects for survival. Although down substantially in recent years, RIG still has a backlog of orders that is significantly higher than its peers totaling $12.2 billion, nearly all of which is for ultra-deep water floaters. Transocean currently has a fleet of 56 drilling rigs, most of which are deep-water floaters.

The company completed the construction of three new ultra-deep-water rigs in 2016 and will complete two more by early 2018. These additions mean that the company has one of the newest fleets in the industry with the ability to be most competitive. The "Deepwater Conqueror" was recently completed and leased to Chevron for drilling in the Gulf of Mexico. Additionally, Suncor extended its contract for 15 months to continue drilling off the coast of Canada. This new contract and extension will provide meaningful revenue in 2017 and 2018.

The long-term profit from RIG should be very good from here. Deep-water drilling is still a necessary source for the US and the world's oil needs, especially as US fracking drops off.

Valero Energy (VLO) was essentially unchanged in 2016 and 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. Profitability in refining is a function of the so-called "crack spread", the difference in the amount a refiner pays for crude oil and the amount for which it sells the resulting refined products such as gasoline and jet fuel. Fluctuations in these prices compress and expand margins which can make refining stocks volatile at times.

Valero is the most complex refiner in the US, which allows it to purchase lower quality crudes when they are priced at the most advantageous discounts. This flexibility allows VLO 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.

Mexico has an inadequate refining network to feed its fast-growing economy and has grown highly dependent on US refiners along the Gulf. This led to a reversal in the US-Mexico balance of trade in 2016 when Mexico became a net importer as refined products to Mexico became greater than crude oil shipments to the US. Valero's Gulf Coast refineries have benefited and should continue to do so.

President-elect Trump's plans to re-negotiate NAFTA are making trade officials nervous, especially south of the border. Mexico's growing reliance on US refiners may be a point of leverage. Trump's cabinet is being staffed by knowledgeable businessmen from the energy industry who will undoubtedly be pushing against any final decisions that would be detrimental to the bi-lateral trade between the two countries.

Real Estate Selections

Real estate stocks have not been exciting since election-day due to the dampening effect of rising bond yields which portend rising mortgage interest rates. It has been our posture for many months that the average real estate investment trust (REIT) does not present a particularly good value. As in the case of bond yields, low interest rates have pushed down real estate capitalization (cap) rates to historically low levels. (The cap rate is the cash yield before debt payments are considered.) As a result, commercial real estate prices are historically high. Accordingly, the *Sound Advice* portfolio only includes real estate stocks offering an extraordinary value now.

Two examples currently exist in the hospitality industry: Hersha (HT) and RLJ Lodging (RLJ). Both are selling at deep discounts to their net asset values and offer high dividend yields.

Hospitality REITs Comparison Table

Company Name	Symbol	Recent Stock Price	Dividend Yield	Stock Market Cap Rate	Portfolio Value @ 7.5% Cap Rate ($Millions)	Stock Value	Discount (-) Premium (+)
RLJ Lodging	RLJ	24.49	5.4%	11.8%	6,472.5	40.80	-46.9%
Hospitality Properties	HPT	31.74	6.4%	10.1%	11,184.6	50.14	-36.7%
Hersha	HT	21.50	5.2%	10.0%	2,305.0	27.71	-32.3%
Host Hotels & Resorts	HST	18.84	4.2%	8.6%	19.2	22.05	-14.6%
Apple Hospitality	APLE	19.98	6.0%	6.8%	4,699.1	17.53	14.0%

The table above shows the "Stock Market Cap Rate" (what the stock price is paying for the underlying real estate portfolio) for several comparable hospitality stocks. The "Stock Value" column shows the current value of the stock assuming the underlying portfolios are valued using a cap rate of 7.5 percent, which is close to the average cap rate on recent hotel transactions. The last column shows the discount or premium at which the stock is trading based on a 7.5 percent cap rate valuation of each company's real estate portfolio.

The table above shows the comparative values of other hospitality REITs. **Hospitality Properties (HPT)** has the second largest discount. However, this company is externally managed by RMR which charges high fees and suppresses value. As long as RMR continues to externally manage HPT, we do not expect to see significant growth. **Host Hotels and Properties (HST)** is very small, with only 749 thousand shares outstanding, which may lead to excessive volatility. Growth may be limited by its small capitalization. **Apple Hospitality (APLE)** is trading at a slight premium.

Hersha Hospitality (HT) gained 4% in 2016 and is a real estate investment trust which owns and operates high quality upscale hotels in urban gateway markets. The Company's 55 hotels totaling 8,654 rooms are located in New York, Boston, Philadelphia, Washington DC, Miami, and select markets on the West Coast. HT is selling at a discount to its hotel assets. Many of HT's major properties have been undergoing renovations and not producing their full income potential. As renovations are completed and rooms are put back on line, revenue and FFO should climb substantially higher. New acquisitions will also contribute to growth, along with sales of less-attractive properties.

In December, HT purchased the 77-room Ambrose Hotel in Santa Monica, CA for $47.5 million with the sale proceeds from two suburban Boston hotels. This transaction exemplifies HT's upgrading assets into high-growth gateway markets. Along the same lines, in 2016, HT acquired 4 hotels in Monterey, Washington DC, Boston, and Silicon Valley.

During the last 2 years, Hersha has reported several hotel transactions it made at cap rates ranging from 5.4 to 8 percent. To be on the conservative side, we can establish a main street cap rate at the high end of this range, of 7.5 percent for valuation purposes.

Based on the latest trailing four quarters' financials, including the most recent 2016 third quarter, and using 7.5 percent cap rate to evaluate the company's portfolio, we value HT at $27.71 per share which is substantially higher than the current price. The dividend yield is attractive and lowers the risk profile. In December, HT declared a special cash dividend of 20 cents per share, in addition to the regular quarterly cash dividend of 28 cents.

RLJ Lodging Trust (RLJ) gained 13.5% in 2016 and has a large, geographically diversified portfolio of 125 hotels, branded by Marriott, Hilton, Hyatt, and Embassy Suites with over 20,000 rooms. Rather than traditional full service hotels, RLJ emphasizes "focused-service" or "compact full service" hotels, where only specially chosen services important for guests are offered. The most important amenity is an attractive, modern room offering quality features for the basic necessities – sleeping, bathing, and working. Minimized are amenities such as large restaurants, spas, and meeting rooms. Overall, the hotels are mid- to up-scale, but with reasonably-priced rooms. This concept translates into a larger portion of revenue from the rooms. The company is on a mission to upgrade its assets by

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purchasing properties in high growth markets with barriers to entry. The company is also seizing opportunities to sell at high prices. In December, RLJ sold two of its New York City hotels: the **Hilton Worldwide** Garden Inn and the Hilton Fashion District hotel. The sale price represented a lofty 4.7 percent cap rate.

RLJ is currently selling at a steep discount to its hotel assets. Based on the latest trailing four quarters' financials reported, including the most recent 2016 third quarter, and using a 7.5 percent cap rate to evaluate the company's portfolio, we value RLJ at $40.80 per share which is considerably higher than the current price. The high dividend yield is attractive and lowers the risk profile.

Retail Opportunities Investment Corp (ROIC) gained 22.1% in 2016 and is a real estate investment trust (REIT) that specializes in the acquisition, ownership and management of grocery-anchored shopping centers located in densely-populated, metropolitan markets across the West Coast. ROIC began as an IPO in 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, FFO is bound to continue rising. The dividend yield is attractive which lowers its risk profile, along with the company's relatively low debt.

Third Avenue Real Estate Value Investor Fund (TVRVX) gained 5.6% in 2016 and is loaded with good 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. The managers expend great effort analyzing financial statements, visiting companies and their properties, and assessing management teams in order to come up with their estimates of intrinsic value. Just as we do at *Sound Advice,* they eat their own cooking – they invest a substantial amount of their personal assets into their funds.

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 searches for opportunities in different aspects of a real estate company's capital structure by investing in senior debt in addition to 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 December, a dividend of 0.1628 per share and long-term capital gain of 0.283 per share were declared.

Medically-Related Selections

Trump believes that the Affordable Care Act (Obamacare) resulted in runaway costs, websites that don't work, greater rationing of care, higher premiums, less competition and fewer choices. He pledges to repeal the Act and lead the effort to bring much-needed free market reforms to the healthcare industry. Although Trump outlines his plans in more detail on his website, the sequence and timing of revamping the government health care provisions is not clear. These sweeping changes also need Congressional approval which adds further uncertainty. How this will all shake out is anyone's guess, which means it is too early to look for new investments in this area. We are comfortable with our current recommendations in this sector based on their own individual merits.

Boston Scientific (BSX) gained 17.3% in 2016 and produces medical products 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. In mid-November, BSX announced positive results from the first clinical trial on its HeartLogic Heart Failure Diagnostic Service to evaluate impending heart failure by combining heart sounds, respiration rate and volume, thoracic impedance, heart rate and activity.

In December, BSX completed the acquisition of specialty medical device company Neovasc Inc.'s NVCN tissue processing technology and facility for $67.9 million. This acquisition is aimed at enhancing innovations and fortifying the Structural Heart segment business, with an immediate benefit to its Lotus valve platform.

Stryker (SYK) gained 30.5% in 2016 and 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.

One of SYK's more significant acquisitions was in December 2013 when it acquired MAKO Surgical and entered the robot-assisted surgery market. In the 2016 third quarter, SYK initiated a limited launch of the "Triathlon" robotic knee replacement surgical system with 200 procedures with satisfactory results. A full launch is planned for 2017 which SYK expects to be successful because of its more consistent and efficient results with less soft tissue disruption.

In December, Stryker declared a 12 percent increase in the quarterly dividend to $0.425 per share.

Tekla Life Sciences Investors (formerly Hambrecht & Quist Life Sciences Fund - the symbol is still HQL) declined 16.4%

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in 2016 and 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 and the source of the world's top breakthrough drugs. 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 – Great Again

The president-elect's proposals are domestically focused and benefit small cap stocks more than others because small caps tend to be domestic companies without substantial overseas exposure. They are typically not buffeted by the currency fluctuations that often haunt larger companies. The Trumponomics benefit is evident by the rise since election-say in the Russell 2000 Index, which is oriented toward small caps.

Numerous studies show that small caps perform better over the long run than the market as a whole. 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.

Third Avenue Small-Cap Value Investor Fund (TVSVX) gained 25.9% in 2016, most of which has been since election-day. This fund 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. In December, a dividend of 0.0649 per share and long-term capital gain of 1.8584 per share were declared.

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) gained 16.5% in 2016 and 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 expanding use of AGU's products. Most of AGU's earnings come from its retail stores, offering farm products with the balance coming 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 free cash flow for future growth.

AGU has been on the rise under the likely assumption that AGU will merge with PotashCorp (POT). Shareholders of both companies have approved the merger and are waiting for clearances from Canadian authorities.

Arconic (ARNC) gained 1.3% in 2016 since the spin-off of the downstream operations of value-added products from Alcoa (AA). Arconic retained a 20 percent interest in Alcoa Corporation which it plans to sell when market conditions improve. Arconic manufactures specialty metals products for aerospace and defense, building and construction, and automotive industries. Arconic is one of only a few companies with the expertise and assets to use uniquely advanced metallurgical techniques to produce metals that can withstand harsh environments, such as within a jet engine, as well as in other vital uses in products that must not fail.

A primary driver of growth is bound to come from the aerospace and defense sectors. Based on the defensive nature of these industries, growth is likely to be more secular than cyclical. The automotive sector is attractive now because more and more auto companies are increasing aluminum content in their cars for fuel efficiency. This trend should also make growth in this sector less cyclical. Stocks that are less cyclical generally command higher P/E ratios.

In December, Arconic completed signing more than $450 million in long term agreements for its forged aluminum wheels which reduce the weight from a tractor trailer by 1,400 pounds. The company also entered into agreements with Airbus, to supply 3D printed metal airframe parts made from high temperature nickel superalloys and titanium.

Apple (AAPL) was essentially unchanged since we added it in 2016. AAPL as a pristine balance sheet, with as much cash as long-term debt, with the highest A++ financial ratings. However, the stock market has been giving APPL a below-average price/earnings (P/E) ratio because of slow and even negative growth prospects. However, the demise of Samsung's latest Galaxy Note 7 phone has flung open the doors for a significant new growth path. Samsung has been Apple's fiercest competitor. Samsung has had 22.4 percent of the market share of smart phones – nearly double that of Apple's 11.8 percent share. Slightly more than one-half (57%) of Apple's revenue comes from its iPhones, so a gain of just one percent in market share translates to 14 million iPhones, which would add 7 percent to revenue. In addition, the new *iPhone 7* and *7 Plus* have been well received which is inaugurating a long-awaited upgrade cycle.

A Trump trade war with China would raise the cost of products brought into the US. On the positive side, lower corporate tax rates would be a large benefit to the company's massive tax burden. Apple has $216 billion stored offshore. Trump's repatriation tax break gives Apple the opportunity to potentially repatriate 37 percent of its market capitalization.

Ford (F) declined 9.7% in 2016 and is in our model portfolio because it is an extraordinary value. Ford's all-aluminum F-150 truck, which gets close to 30 miles to the gallon, has been Ford's best-selling vehicle in the US for 34 consecutive years, and the company's most profitable product.

Trump's rhetoric against trade has been a cloud over the car industry. NAFTA provides automakers with access to cheap labor. The other cloud is the Corporate Average Fuel Economy (CAFE) standards requiring miles-per-gallon ratings to become more efficient by 2025. These two clouds are part of the same storm because it is not profitable to build small cars in the US, and making small cars is a primary way of meeting the CAFE standards. Another way to meet the standards is to make more all-aluminum larger cars, SUVs, and trucks (like Ford's F-150). In this regard, Ford is well positioned as a leader.

The uncertainty over Trump's anti-trade plans has forced Ford

stock to sell at a huge discount to the rest of the market. The dividend yield is close to 5 percent puts a floor under the stock price and provides a nice yield while we wait for less uncertain times.

NCR Corp (NCR) gained 65.8% in 2016 and 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.

Management expects NCR's 2016 earnings to be close to $3.00 per share. NCR has climbed substantially recently, but it is still selling at 14 times earnings, which is below the market average.

Symantec (SYMC) gained 43% in 2016 and is the dominant supplier of software for computer security and protection against viruses and other nuisances. 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.

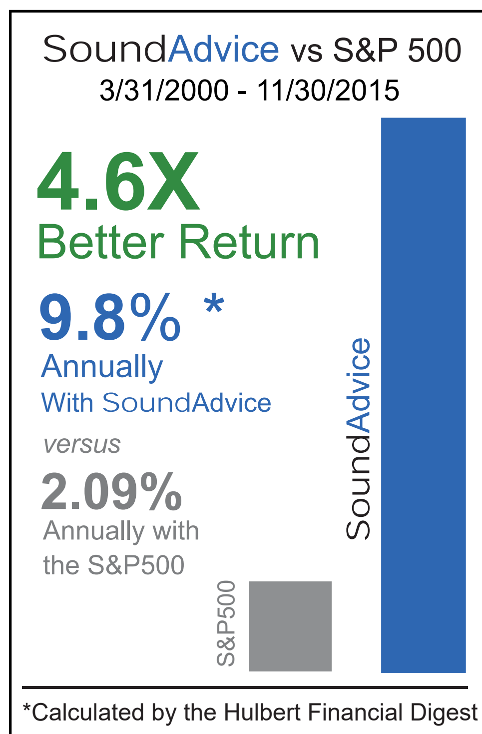
SYMC is expanding through acquisitions. In November, it acquired LifeLock, the identity theft protection company which should give an immediate boost to Symantec's top line. In October, SYMC entered into a partnership with Blue Coat to integrate its cyber threat intelligence capabilities with artificial intelligence.

SYMC furnished a nice investment return in 2016, especially considering its $4.00 dividend paid in February.

Tetra Tech (TTEK) gained 66.9% in 2016 and is a leading company in water technologies and environmental remediation with a healthy balance sheet for growth in strategic markets. Two recent acquisitions of Coffey and INDUS corporations have swelled TTEK's backlog of contracts and increased prospects for more Federal contracts in the IT sector. The company's backlog is now $2.3 billion, which reveals a robust pipeline with major government organizations like the US Department of State, US Army Corps of Engineers, and the US Air Force, which should continue to bolster growth.

Wells Fargo (WFC) was recently added to the portfolio because it is timely. Bank stocks have been soaring since election-day because rising interest rates will increase profit margins, and the prospect of some deregulation will expand business opportunities. However, WFC has not participated in the rally due to the scandal a few months ago regarding unauthorized account-opening practices. While there may still be some fall-out, management has changed and the issue is basically history. The relatively low price of WFC makes it a strong value and a timely investment.

Wells Fargo is consistently among the largest receiver of deposits with its strong market position in metropolitan markets throughout the US. It is also one of the best lenders, offering competitive mortgage loans on reasonable and attractive terms, especially in the commercial area. This gives WFC a high level of profitability.



*Calculated by the Hulbert Financial Digest

One of the problems with banks stocks is the complicated nature of their business activities which makes analysis difficult. However, Wells Fargo has a less complicated business model than most other banks, which gives its strong balance sheet good visibility, with very little in the way of opaque balance sheet items. Most of the items on the balance sheet are what one would expect: consumer and commercial loans and investments in securities.

WFC is trading at less than 14 times earnings, which is substantially below the market average. Accordingly, WFC is presenting a good value and offers growth from rising interest rates, both in the stock price as well as the yield. WFC has a history of increasing dividends along with rising earnings.

Under conservative assumptions, 2017 earnings are expected to be $4.45 per share. This puts the current stock price less than 13 times 2017 earnings. Even with no expansion in the current price/earnings (P/E) ratio of 14, the stock would be $62 based on 2017 earnings. However, we expect more upside because the P/E ratio should expand due to brighter growth prospects. At a P/E ratio of, say 18 which is still below the overall market average, WFC would be $80 per share – 45 percent more than it is now.

Xerox (XRX) declined 15% in 2016 and is continuing to transform from a seller of printers and copiers to a company providing information technology (IT) services and document outsourcing (printing as a service). The services side now amounts to 55 percent of revenues. For much of 2016, XRX has been planning to split into two companies by the end of the year; one with the printers and other equipment and the other offering the IT services. The company predicts that the split will save $2.4 billion during the first 3 years. Carl Icahn, who holds 82 million shares, believes XRX is undervalued and believes the split will improve management's efficiency and focus. After the company spits and we see the details, we will opine on what to do.

Hedging the Portfolio

We are also recommending a reverse ETF that essentially short-sells the market and will benefit from down-drafts in the S&P 500.

The **ProShares UltraShort S&P 500 (SDS)** declined 24.2% in 2016. This ETF 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.

Energy/Natural Resources	Symbol	Price / NAV	Yield	Action	Limit
Chesapeake Energy Corp	CHK	$7.02	0.00%	BUY	$8.00
Chevron	CVX	$117.70	3.67%	BUY	$120.00
Fidelity Select Nat. Gas Fund	FSNGX	$29.58	0.42%	BUY	$32.00
Freeport-McMoRan	FCX	$13.19	0.00%	BUY	$15.00
ICON Energy Fund Class S	ICENX	$13.57	0.40%	BUY	$14.50
Transocean	RIG	$14.74	0.00%	BUY	$16.00
Valero	VLO	$68.32	3.51%	BUY	$72.00
Real Estate					
Hersha Hospitality Trust	HT	$21.50	5.21%	BUY	$23.00
Retail Opportunity Investment Corp	ROIC	$21.13	3.41%	BUY	$23.00
RLJ Lodging Trust	RLJ	$24.49	5.39%	BUY	$26.00
Third Avenue Real Estate Value Investor	TVRVX	$29.73	0.55%	BUY	$32.00
Medically Related					
Boston Scientific	BSX	$21.63	0.00%	BUY	$23.00
Stryker Corp.	SYK	$119.81	1.42%	BUY	$123.00
Tekla Life Sciences Fund	HQL	$16.99	0.00%	BUY	$19.00
Small Caps					
Third Avenue Small-Cap Value Investor Fund	TVSVX	$21.50	0.30%	BUY	$23.00
Special Situations					
Agrium	AGU	$100.55	3.48%	BUY	$108.00
Apple	AAPL	$115.82	1.97%	BUY	$120.00
Arconic	ARNC	$18.54	1.94%	BUY	$20.00
Ford Motor Company	F	$12.13	5.77%	BUY	$13.50
NCR Corp	NCR	$40.56	0.00%	BUY	$43.00
Symantec	SYMC	$23.89	1.34%	BUY	$26.00
Tetra Tech	TTEK	$43.15	0.83%	BUY	$45.00
Wells Fargo	**WFC**	**$55.11**	**2.76%**	**BUY**	**$60.00**
Xerox	XRX	$8.73	3.21%	BUY	$10.00
ETFs for Rising Interest Rates					
ETF - Direxion Daily 20+ Yr Bear 3X	TMV	$23.98	0.00%	BUY	$27.00
ETF - ProShares Short 20+ Year Trsry	TBF	$23.89	0.00%	BUY	$25.00
ETF - ProShares UltraShort 20+ Year Trsry	TBT	$40.82	0.00%	BUY	$44.00
Hedges					
S&P 500 ProShares Ultra Short ETF	SDS	$15.11	0.00%	BUY	$17.00

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 12/30/2016. See our website for live pricing and buy limits:
http://www.soundadvice-newsletter.com/members
The right hand column is the highest recommended price limit for purchases.

General Comments:

Our statistics are based on the assumption that $10,000 is invested in each position. When a new position is added, we assume the same $10,000 amount is invested in the new recommendation. When we recommend adding to a particular position, as we have done over the years, we assume another $10,000 is invested again in that position.

If you are picking and choosing, you can focus on the sector of the portfolio that matches your investment objectives. The table above divides the portfolio into four sectors; Income with Growth, Diversified Growth, Energy and Natural Resources, and Aggressive Growth.

Alternatively, you may have a higher degree of comfort with certain industries, funds, or stocks because of past experience or your profession. In that case, you may want to invest more heavily in one sector, or in one or more individual recommendations.

As always, broad diversification will temper volatility, add to safety, and improve long-term performance.

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 under performing 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.

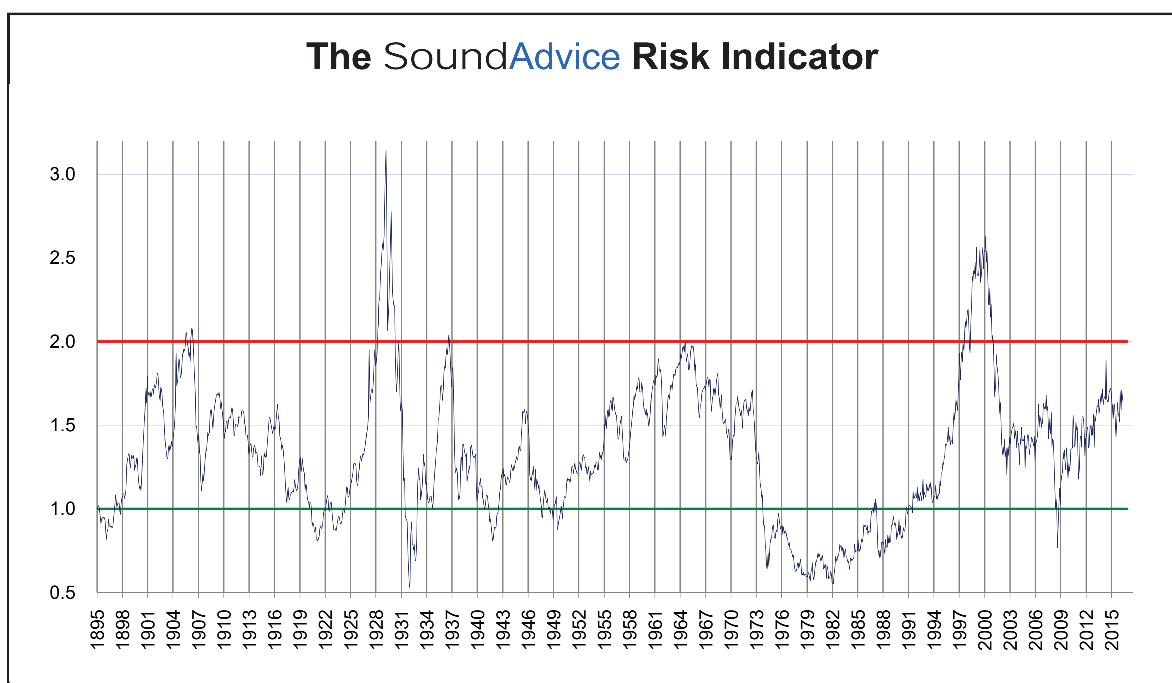
The figures show that over the entire century-plus, stock prices have outperformed housing prices. Just based on the price growth of each investment market and assuming no leverage was used, a $25,000 investment would have grown to $13.2 million in stocks and to $1.67 million in houses.

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 $523 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 latest reading for the SoundAdvice Risk Indicator is 1.66. 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 the Stock Market*** for a complete explanation of the SoundAdvice Risk Indicator and its track record.



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 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.

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. This reading reveals that the US economy is strong enough to put upward pressures on interest rates.

We have been operating under a "Caution" signal since the June 2015 release of the May lagging economic indicators. This was just after the S&P 500 peaked at 2,130.82 on May 27, 2015.

The SoundAdvice Diffusion Index of LAGGING Indicators was 67 percent in November (the most recent data). This is follows a consecutive string of five 100 percent readings.

Our next signal will come from the SoundAdvice **Diffusion Index of LEADING Indicators** when it drops to zero. **The latest reading for November was 100 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 32.1 percent. During "Caution" signals, the S&P 500 increased an average of 3.0 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 +/-	32.1%		3.0%

See ***The Science of Making Money in the Stock Market*** for a complete explanation of the **Sound**Advice Diffusion Indexes and their track records.

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