



How a New Berkshire Hathaway Is Being Born in Secret

Berkshire Hathaway is the world's most valuable single share of stock.

Each share trades for more than \$175,000. That's roughly four times the median annual income in the United States.

The high price largely reflects the fact that Berkshire Hathaway is run by Warren Buffett. Berkshire Hathaway's chairman and CEO since 1964, Buffett is widely regarded as the world's best investor. If you've read this *Investment Advisory* any length of time, you know our regard for him. It's hard to think of an investor whose track record we admire more...

There is little we could write in these pages about Warren Buffett that you probably don't already know.

However, we are certain you know nothing, or almost nothing, about a man who is deliberately following in Buffett's footsteps. He is, like Buffett, one of the greatest investors of his generation. And like Buffett, he has gained control of a giant, failing business with a huge reserve of hidden assets. He is slowly transforming these wasted assets into a massive reinsurance firm. He is following Buffett's precise playbook. And so far... almost no one knows it.

But... before we tell you about these secrets... let's go over a few of the key facts from Berkshire history just to make sure we're on the same page.

In 1955, two massive New England textile firms – Berkshire Fine Spinning Associates and Hathaway Manufacturing Company – merged to form Berkshire Hathaway. At that point, the two companies had a combined 183-year history in cotton, textiles, and manufacturing. The newly merged company employed 12,000 workers and 15 plants to generate more than \$120 million a year in revenues. The combination was, at the time, a business colossus.

But... by the early 1960s, Berkshire Hathaway was entrenched in terminal decline. The textile industry had moved south to nonunion states, where plants could offer higher-quality textiles at vastly lower prices.

Warren Buffett – who at the time controlled a small Omaha-based investment partnership (what we'd call a hedge fund today) – began accumulating shares. He saw the dichotomy between the company's net asset value and its share price as irresistible. To prevent Buffett from gaining control of the company (and perhaps liquidating the assets), Berkshire Hathaway CEO Seabury Stanton agreed to buy back Buffett's shares for \$11.50. They shook on it. But when Stanton's written letter came in, Buffett noticed Stanton had offered \$11.38. Buffett explained in an interview with the financial news channel CNBC:

If that letter had come through at \$11.50, I would have (sold) my stock... But he chiseled me for (\$0.12 per share)! This made me mad. So I went out and... bought control of the company, and fired Mr. Stanton.

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Editor: Porter Stansberry

Had Seabury Stanton not tried to weasel an extra \$0.12 a share out of Warren Buffett, none of us would ever have heard of Berkshire Hathaway.

Stanton's actions caused even his partners in Berkshire Hathaway, the Chase family, to doubt his integrity. Malcolm Chase sold a critical, controlling block of stock to Buffett. The family has remained a faithful Berkshire Hathaway shareholder since then. Malcolm Chase served on Berkshire Hathaway's board until he was 88 years old. His family's stake is now worth more than \$1 billion.

Rather than continuing to reinvest the company's profits into textiles, Buffett moved the company into insurance, buying National Indemnity in 1967. And as insurance began to add "float" to the company's balance sheet, Buffett began investing in many different industries – always, however, preferring long-term investments in the highest-quality "franchises" at rock-bottom prices.

Still... Buffet held onto the textile business. Even though he clearly knew the economics of the textile industry were bleak, he stuck with the legacy business for 20 years. Buffett calls this decision his biggest investment mistake. He bought Berkshire Hathaway to spite Seabury Stanton... then he compounded the problem by sticking with the textile business.

I committed a major amount of money to a terrible business... Berkshire Hathaway was carrying this anchor of all these textile assets... for 20 years I fought the textile business before I gave up. If instead of putting that money into the textile business had we just (invested) in the insurance company, Berkshire would be worth about twice as much as it is now. This is \$200 billion (we lost) because (I) thought I could run a textile business... It was a terrible mistake.

The moral of the story, according to Buffett: "If you get in a lousy business... get out of it."

In this issue, we're going to tell you about two hedge-fund managers who got themselves into lousy businesses. One of these young hotshot investors appears to have learned from Buffett's mistake. One has not.

The Tale of Two Failing Retailers

It seems clear to us (and just about everyone else too) that **Sears Holdings (Nasdaq: SHLD)** and **J.C. Penney (NYSE: JCP)** can't survive in the current retail environment.

We first recommended shorting Sears in this newsletter nearly 15 years ago. It was apparent, even then, that the company's locations and merchandising were third-rate. Today, online retailers like Amazon and

deep-discount retailers like Wal-Mart and Costco make it even more certain that Sears can't thrive and won't survive.

The same things are true for J.C. Penney – although it's in even worse shape today... for reasons that we will detail shortly.

Both Sears and J.C. Penney are iconic brands that enjoyed 100-year runs of profitability. Both were integral parts of America's shopping mall explosion in the 1960s. Today, most J.C. Penney and Sears stores remain anchored in malls – places where fewer and fewer Americans shop. Both J.C. Penney and Sears ran popular catalog businesses until the early 1990s. And neither could successfully move their catalog businesses onto the Internet. As a result... both fell on hard times in the 1990s.

And finally... much like the dying Berkshire Hathaway in 1965... both Sears and J.C. Penney ended up being controlled by hedge-fund managers.

The J.C. Penney-Ackman Debacle

In 2010, with J.C. Penney's revenues sliding steadily, Bill Ackman of the Pershing Square hedge fund began accumulating shares of the retailer.

After gaining control of the company, Ackman fired Penney's CEO Myron Ullman. Ackman replaced Ullman with Ron Johnson – the former Target merchandise head who'd launched Apple's slick retail stores. As Ackman enthusiastically explained in his November 22, 2011 letter to investors:

We expect... a fundamental transformation in the business under an extremely talented and experienced new senior management team... I expect to look back on the decision by the company to hire Ron, and our role in identifying and recruiting him, as one of the most significant contributions that we have ever made to any company over the life of our firm.

Ackman went on to praise the retail All-Stars assembled by Johnson, including Michael Francis from Target, who Ackman said was "considered the best marketer in the business." Despite mountains of financial evidence suggesting that J.C. Penney could not compete in modern retail, Ackman was convinced the problems could be "managed" away.

Somewhere, Warren Buffett must have rolled his eyes. Buffett has famously quipped that when a manager with a great reputation takes on a business with terrible economics, the business always emerges with its reputation intact.

Nevertheless, pockets flush with more than \$50 million in upfront compensation, Ron Johnson started his

J.C. Penney turnaround in late 2011.

J.C. Penney's core customer base is conservative, "red state," coupon-cutting housewives. These are deal-hunting moms who appreciate value. It was clear from the beginning that J.C. Penney's new owner – a highly educated, sophisticated New York money manager – and management team – fresh off its Silicon Valley triumphs – knew little or nothing about mainstream American mall shoppers. And cared less.

Ackman's team got rid of coupons. They hired an openly gay spokesperson and put a lesbian family on the cover of the in-store magazine. If they were trying to alienate their customer base, these guys couldn't have done a better job. It was complete disaster.

Francis – "the best marketer in the business" – was canned barely six months after joining. Johnson and the rest of his All Stars lasted about 17 months. Each left with millions of dollars in parting compensation, a particularly generous reward considering they lopped 25% (\$4 billion) off the company's revenues. Ackman had promised investors a "fundamental transformation." And he gave them one: Johnson and crew managed to transform a bad retailer into a *horrible* retailer on the verge of bankruptcy.

Ackman and the J.C. Penney board eventually persuaded Myron "Mike" Ullman to return to the company as interim CEO and help forestall the inevitable. (Just imagine that conversation...)

Now in its TV ads, J.C. Penney must first apologize for all of the nonsense Ackman's team inflicted on the company and its customer base. In the latest ads, a piano softly pecks out an optimistic melody while the camera pans to old J.C. Penney storefronts, where good-looking people stare at sunsets and children hug. Meanwhile, an awkward female voiceover quietly apologizes...

It's no secret. Recently, J.C. Penney changed. Some changes you liked. And some you didn't. But what matters with mistakes is what we learn. We learned a very simple thing. To listen to you... Come back to J.C. Penney.

We can't recall ever seeing that kind of corporate apology broadcast over TV advertising before. The whole story is simply hard to believe. After showering Ackman's "extremely talented management team" with more than \$100 million in compensation, J.C. Penney shareholders now get to fund an ad campaign apologizing for their efforts. Aside from New Coke, there has never been a more colossal failure in the history of marketing.

J.C. Penney lost more than \$500 million in the fourth quarter of 2012 alone. For the entire year, the company burned through \$1 billion in cash. In May, Goldman Sachs threw J.C. Penney a \$2 billion lifeline. This buys J.C. Penney some time with its immediate

liquidity needs. But the loan is secured by the company's most valuable asset – its real estate portfolio. We project J.C. Penney will burn through another \$1.1 billion of cash flow in 2013... and another \$500 million-plus in 2014... if it survives at all.

Meanwhile, thanks to the terms of the new Goldman loan, the company has limited its ability to finance operations by liquidating assets. J.C. Penney offers us an opportunity to short an obsolete business burdened by a high debt load.

As we brought this issue to publication, Ackman's tenure with J.C. Penney came to a head...

Last week, Ackman began to leak information about boardroom discussions for finding a permanent replacement for Mike Ullman. (Remember he's the "interim" chief.) Ackman publicized a letter in which he claimed to have persuaded Allen Questrom – himself a former J.C. Penney CEO – to return to his old position. The board publicly reprimanded Ackman for leaking private conversations. Meanwhile, George Soros – another hedge-fund manager with a JCP stake – continued to publicly back Mike Ullman. On August 13, Ackman resigned from the J.C. Penney board.

This saga played out in the worst possible way. It has been an unmitigated disaster. But ultimately, this drama is just noise. Regardless of Ackman's involvement (or lack thereof) J.C. Penney is doomed. The dying retailer has passed the point of no return... no matter who sits in the corner office or boardroom.

The Lampert Approach... Building a Secret Berkshire Hathaway

No one has ever accomplished more, in a shorter period of time, on Wall Street, than Edward Lampert.

In 1984, Eddie Lampert graduated summa cum laude from Yale. His first job out of college was working on the most prestigious trading desk on Wall Street – Robert Rubin's risk-arbitrage group at Goldman Sachs. By 1988, Lampert decided to start his own firm. He was only four years out of Yale.

Fund manager Richard Rainwater gave him \$28 million to manage, and introduced him to a world of mega-clients, like David Geffen. By 2004, Lampert had become the first hedge-fund manager to earn \$1 billion in a single year. By 2006, he was the richest man in Connecticut, with a net worth more than \$3 billion.

He became wealthy by making money for his clients at a Buffett-like pace – more than 20% a year. And like Buffett, Lampert wasn't afraid of making big, concentrated bets.

In 2003, Lampert purchased most of the outstand-

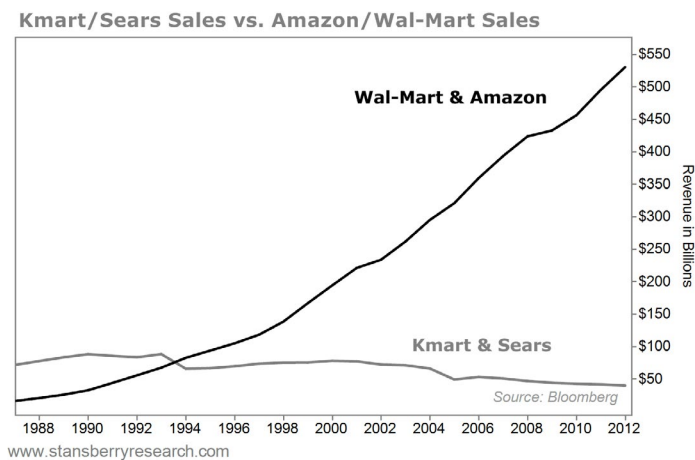
ing debt of Kmart, which was two years into a prolonged bankruptcy process. Lampert – an expert in the nuances of bankruptcy proceedings and asset distributions – managed to accelerate Kmart’s bankruptcy process and walked away with control of the company. The deal made him, his partners, and other investors in Kmart’s defaulted bonds gains in excess of 1,000%.

About a year later, acting as Kmart’s chairman, Lampert decided to reinvest these winnings by merging Kmart with Sears Roebuck, forming Sears Holdings.

Most market commentators believe that Lampert has made a classic mistake of trying to turn around a business in a failing industry – a “value trap.”

Both Market Watch and *Forbes* magazine have bestowed on Lampert the infamous “America’s Worst CEO” title. And Moneywatch says Lampert “is completely over his head.”

We, too, have thrown some dirt on what seemed like Lampert’s misadventures in retailing. We have pointed out, many times, that Sears Holdings can’t compete effectively against Wal-Mart or Amazon. Just take a look at the chart below. You’ll see how the combined revenues of Kmart and Sears compared with those of Wal-Mart and Amazon.



The facts are clear and easy to understand...

Since 1987, the combined annual revenues of Kmart and Sears have dropped from nearly \$100 billion to less than \$40 billion. Meanwhile, Wal-Mart and Amazon sales have blown up from \$15 billion to more than \$500 billion.

All of Sears and Kmart’s operational metrics – profit margins; earnings before interest, taxes, depreciation, and amortization (EBITDA); cash flows; net income; etc. – have deteriorated significantly since 2006. The liquidity situation at Sears Holding is particularly bad. As of the latest regulatory filing, from May, Sears Holdings had \$471 million in cash, which is barely enough

to cover six months of its expenses. The debt market has started to take notice. Its bond prices are dropping and default insurance is soaring.

So... If everything is so ugly at Kmart and Sears, why is Lampert still buying the stock – lots of it? Lampert has consistently added to his position, and currently owns around 55% of Sears Holdings. The next biggest shareholder (fund manager Bruce Berkowitz) isn’t selling, either... and he’s no dummy. Berkowitz’s Fairholme Fund owns about 18% of Sears Holdings. In 2010, Morningstar ranked Berkowitz as the No. 1 fund manager *of the entire decade of the 2000s*.

So why are these value-investing superstars invested in Sears Holdings? We assure you, they’re not investing in a retail turnaround.

You see, these value-based titans are sum-of-the-parts guys. They understand that sometimes a company’s value comes from its assets, not its ability to generate operating cash flow. Recently, Lampert has done a good job generating more than \$1 billion in cash from Sears Holdings assets, by spinning off new companies and selling real estate.

So how much value is left in Sears Holdings?

We’ve spent a lot of time trying to answer that question. It’s not as simple as checking the asset values on the balance sheet. You see, Generally Accepted Accounting Principles (GAAP) can vastly understate the actual value of an asset. GAAP does not adjust the balance sheet to reflect increases in property values. Over a period of decades, this “unadjusted” value can add up. As Berkowitz recently quipped: “If the Dutch still owned Manhattan, GAAP would value the entire island at the \$27 price.”

Fortunately, a recent flurry of real estate activity in the mall and large retail markets gives us a clue. Lampert has sold off or closed dozens of Sears Holdings stores and there have been many other big deals, so we’ve got plenty of real estate “comps” to help us estimate the liquidation value of the Sears Holdings real estate. Taking a blended national rate for both rented and owned Sears Holdings properties, we conservatively estimate that the liquidation value of the Sears Holdings real estate is \$20 billion-\$30 billion. Yes, that’s right: \$20 billion to \$30 billion.

If you apply more specific regional rates to the Sears real estate portfolio, the value actually comes in slightly higher. While you can try to pinpoint the “true” value of the real estate in dozens of ways... our analysis of relevant comps confirms Berkowitz’s assessment: “Any way you slice and dice it, the real estate is worth multiples of the stock price.”

The hundreds of recent store closings also provide evidence of the value trapped on the Sears balance sheet. The 300 Sears and Kmart stores that have closed since

2006 generated GAAP gains of nearly \$1 billion. In other words, the actual cash received from those sales exceeded their balance-sheet, GAAP value by \$1 billion. Eddie made more than \$3 million every time he shut down a store. *The inventory sales alone more than covered severance and other closing costs.* After weighing all of these data points, we believe the balance sheet value of inventory – roughly \$7 billion – is a fairly accurate reflection of true liquidation value.

So that's \$20 billion-\$30 billion in real estate and \$7 billion in inventory. Subtract \$16 billion in liabilities and you get somewhere around \$11 billion to \$21 billion in value *just in inventory and real estate.* The stock currently trades for less than \$5 billion in market cap. The company's net assets in liquidation are probably worth three times more.

By now you can see why this stock is so volatile. The bulls see value in the underlying assets. The bears believe that the bullish liquidation analyses are way too optimistic and choose to focus on the dying retail business. This is where most articles on Sears Holdings end. But we're just getting started.

Lampert's Hidden Treasure Chest

In 2011, Eddie Lampert did something 99.9% of the investing public didn't notice... and almost surely would never be able to figure out.

He filed a "Second Amended and Restated Credit Agreement" with the Security and Exchange Commission. What's that? We'll get to that...

But first, you need to know that Sears Holdings is actually a complicated web of subsidiaries, special purpose entities, holding companies, and other affiliates. It's complicated because that's the way Lampert wants it. He doesn't want to make it easy for anyone to figure out what's really happening at Sears. The longer he can keep the secret, the cheaper he can buy shares.

Today, after years of machinations, Sears Holdings' various business interests fit into two critical categories – guarantor subsidiaries and nonguarantor subsidiaries. The first category of assets can be used to pay back bondholders in the event of a Sears Holdings bankruptcy. The nonguarantor subsidiaries are shielded from bondholders in the event of a Sears Holdings bankruptcy.

See where this is heading?

Lampert – who, again, is widely regarded as an expert in bankruptcies and company liquidations – is attempting to make Sears' best assets *untouchable* in the event of a Sears Holdings bankruptcy. Meanwhile, the assets still engaged in the dying retail business remain Sears' "guarantor subsidiaries." So in the event of bankruptcy, the bondholders are stuck with the retail assets.

Now... let us show you what Lampert hopes you never find... his crown jewel: Sears Holdings' largest non-guarantor entity – Bermuda-based Sears Reinsurance.

Just like Buffett did back in the 1970s with the remnants of Berkshire, Eddie Lampert has been building a huge insurance company from the remnants of Sears.

Today, Sears Reinsurance holds an incredible \$35 billion in assets. Very few people know anything about this insurance company. And since it's not publicly traded, Sears Reinsurance largely flies under the radar.

Studying all the filings, it's become clear to us that Sears Reinsurance is the core of Lampert's strategy. Lampert has transferred billions of dollars of assets from guarantor subsidiaries (where debtors have claim) to Sears Reinsurance (where debtors have no claim). Specifically:

- Sears Holdings transferred 125 of its best properties to a "special purpose entity" and agreed to lease these properties back from this special purpose entity. Then, using a creative combination of mortgages and mortgage-backed securities, the value of these properties (\$1.25 billion) ended up as securitized assets on the Sears Reinsurance books. Furthermore, the lease payments for these trophy properties flow into Sears Reinsurance every month, in the form of loan payments on the securitized assets.

Essentially, Lampert legally transferred extremely valuable real estate assets and the cash flow they generate into an entity that bondholders can't touch.

- While the real estate move was brilliant... Lampert's next move was literally groundbreaking. *BusinessWeek* gushed: "Sears is on the cutting edge of a financial innovation so important it could... change the way managers of a wide range of businesses think about their balance sheets." Using a special purpose entity, a royalty agreement, and "asset backed notes," Sears Holdings effectively transferred to Sears Reinsurance the \$1.8 billion intangible value associated with the brand names Kenmore, Craftsman, and Die-Hard.

As a result of these arrangements, Sears Holdings now must pay royalties every time a Kenmore, Craftsman, or Die-Hard product is sold... As you probably guessed, Lampert structured the deal so that the royalty payments ultimately go to Sears Reinsurance. So Lampert created licensing income from thin air – and assigned that income to his insurance company.

While it's plain to see that this insurance company is the key to Lampert's strategy, it's much less clear what this insurance company actually *does*. According to filings, Sears Reinsurance assumes the risks for Sears Holdings' product/service warranty contracts, its workers comp claims, some risks associated with Sears receivables, and other property-and-casualty risks. It would seem that, with \$35 billion in assets, Sears Reinsurance must certainly be engaged in business outside Sears and Kmart risks... but company filings are largely mum on the topic.

It's possible there's a document filed somewhere that helps explain the nature of Sears Reinsurance's business. But we haven't found it. Regardless, here's what we do know...

Through some creative asset-backed securities, the value of Sears Holdings' 125 most valuable real estate properties and three most valuable brand names sits on the balance sheet of an insurance company that is shielded from debtors in a Sears Holdings bankruptcy. Furthermore, every time a Craftsman power tool is sold, a Die-Hard battery is installed, a Kenmore washer/dryer is delivered... every time rent is paid on one of Sears' 125 most valuable properties... every time a worker's comp premium is paid... all of this cash cascades through a litany of Sears Holdings entities and lands at this same bankruptcy-shielded insurance company.

While we have some unresolved questions about the nature of the Sears Reinsurance business, the results speak for themselves.

Cash Flow Provided by Operating Activities			
	Guarantor Subsidiaries (Sears Retail)	Nonguarantor Subsidiaries (Sears Insurance)	Consolidated
2010	-\$1,115	\$1,245	\$130
2011	-\$1,506	\$1,199	-\$307
2012	-\$1,356	\$1,053	-\$303
	-\$3,977	\$3,497	-\$480

As you can see, Sears Holdings is really two companies. One that makes money and will be preserved in the event of bankruptcy... and one that loses money and will be liquidated in the event of bankruptcy.

Does Lampert Even Care About Retail? Should He?

The numbers at Sears Holdings are so ugly, it would take huge efforts to turn this retail nightmare around.

Sears Holdings lost \$4.69 per share in 2012... and analysts are predicting losses of an additional \$8 per

share in total per-share losses from 2013-2015.

Meanwhile, Lampert doesn't appear to be very concerned. He lives and works in South Florida, 1,400 miles away from the company's Chicago headquarters. And some of Lampert's managerial actions – or lack thereof – seem inconsistent with a man with a 55% stake in the company.

For example, *Businessweek* published some startling statistics about Sears and Kmart capital expenditures. (Capital expenditures are cash paid for updating equipment, revamping stores, improving distribution, etc.) Lampert is spending only \$2.50 per square foot on capital expenditures, compared with more than \$10 per square foot for Target and \$9 per square foot at Wal-Mart. Even Home Depot with its stark décor spends more than \$5.50 per square foot on capital expenditures. Lampert is starving Sears of capital. He knows that doing so will bankrupt the business.

This leads us to believe Lampert is only giving token effort to turning around Sears' retail operations. We think his actions are consistent with a liquidation strategy, as opposed to a retail strategy.

Of course, Lampert has been spraying all kinds of retail-improvement ideas across customers and employees alike. Some initiatives – like employee loyalty program “Shop Your Way” and the “MyGofer” same-day delivery service – have been fairly successful and forward-thinking. Sears has also made some meaningful strides with e-commerce, although it may be too little too late. Other ideas – like an online employee idea exchange and inventory-checking iPads for salespeople – have flopped.

Businessweek recently published an article that focused on a restructuring plan called “Sears Organization, Actions, and Responsibilities” (SOAR). The initiative split Sears Holdings into 30 separate minicompanies – tires, appliances, sporting goods, etc. Each has its own CEO, chief financial officer, and board of directors. The minicompanies compete with one another for capital, resources, and even ad space. Former executives called the SOAR program a divisive disaster. However, chopping up a company into 30 completely autonomous entities makes perfect sense if Lampert is positioning the units for a quick and easy sale or spin-off.

We believe the end is drawing near.

Lampert and his funds own 55% of a company that the market values at \$5 billion. So today, Lampert's share in Sears is worth about \$2.8 billion. Even if the stock popped 50%, Lampert's share would “only” be around \$4.1 billion.

But based on the valuation exercise above... if SHLD were able to slowly liquidate, Lampert would end up with a 55% stake in \$11 billion-\$21 billion

of cash or other assets even if he chose to pay off all debts. (A stake totaling \$6.1 billion-\$11.6 billion.) In essence, he'd be better off liquidating Sears.

Plus, the cash-gushing insurance business and Craftsman, Kenmore, and Die-Hard royalties remain completely intact for Lampert and the other shareholders. Berkowitz sums up the situation well: “[Lampert] is going to try to make a go of it (fix retail) and if he doesn't make a go of it, he's going to slowly sell the real estate. So I just don't see how we lose.”

Lampert may try to shake a little life into this tired old retail company... But ultimately, this is a liquidation play. Lampert is not going to spend any real money trying to turn around his stores.

Sears Holdings is the most complicated corporate structure we've ever analyzed. If you want to dig through the filings yourself, have at it. We did. And we believe it all boils down to this:

Lampert is engaged in a liquidation strategy, as opposed to a genuine retail turnaround.

Through a series of unprecedented and unnoticed legal maneuvers, Lampert has been siphoning cash *away* from his retail business and into a mysterious, cash-producing insurance company.

Lampert, who is an expert in bankruptcy asset distributions, took great pains to amend and restate his credit agreements to ensure that his favorite assets – the insurance company and the brand names – are shielded from bondholders in the event of a bankruptcy.

How to Play This Unique Situation

Let us return, for a moment, to Warren Buffett's advice. “If you get in a lousy business... get out of it.”

Which of these hedge-fund superstars – Ackman or Lampert – heeded that advice? Which one is quietly monetizing valuable assets that had been accumulated over decades? Which one threw perfectly good money at a high-priced executive and a celebrity spokesperson? Which one is quietly starving a dying business while feeding insurance (which is exactly what Buffett wishes he had done)?

Let's face it. Sears, Kmart, and J.C. Penney are obsolete retailers from a bygone era. There's no shame in that. They had a great run. But all companies die off at some point. In the 1960s, it became impossible for Berkshire Hathaway's textile business to survive with the rise of nonunionized Southern rivals and increasing competition from overseas. After 130 years, it was time to fold up the tent and move on.

Sears, Kmart, and J.C. Penney face similar head-

winds today. These stores are not cheap enough to compete on value with Wal-Mart... They aren't high-end enough to compete with Target... They don't have the online chops to compete with Amazon... and they are not small enough to nimbly change strategies at their mall-focused locations. They're caught in retail no-man's land. No amount of spending is going to change that.

In his November 2011 letter to investors, Bill Ackman summed up both company strategies well:

The Sears strategy over the last seven years appears tantamount to that of a liquidation. The company has starved the store base from needed investments and used the resulting cash flows for share buybacks... By comparison, our approach to effectuating change at JCP has principally been to identify and recruit the best retail CEO in the industry to run the company.

With the benefit of hindsight, it's obvious that Mr. Ackman chose the wrong strategy.

Even if the next leadership at J.C. Penney wanted to take a “Lampert-like” approach... it's too late. With the Goldman Sachs lifeline, J.C. Penney effectively mortgaged its most valuable assets and the CFO announced the company will use that money to continue “building” its brand. Meanwhile, J.C. Penney still doesn't have a permanent CEO in place. This will not end well.

Ackman's departure from the J.C. Penney board may create some short-term optimism around the stock. We think it will be fleeting. No one can turn around the fortunes of mall-bound department stores... and its assets are all mortgaged.

We recommend you **SHORT shares of J.C. Penney (NYSE: JCP) when they trade for more than \$12.50, and BUY Sears Holdings (Nasdaq: SHLD) shares up to \$45 a share.** Use a 25% trailing stop loss on the combined position.

This long-short combination is known as a “pairs trade.” You see, we believe there is upside to Sears Holdings. But there is downside risk as well. As we mentioned, Sears has a liquidity crunch of its own that will rely on Lampert to continue to monetize assets to succeed. There are also macro headwinds. SHLD has a large short interest, and the market is poised for a potentially large correction.

But by simultaneously shorting a retailer that's in even worse shape, we have hedged our downside should the Sears Holdings investment turn south. If the overall economy or the market's retail concerns were to cause our Sears Holdings investment to tank, our losses should be offset by a corresponding drop in J.C. Penney.

How to Make ‘Amplified’ Gains on the Third Shale Revolution

We’ve been writing about America’s new oil boom since April 2010, an issue titled “All the Oil in Texas.”

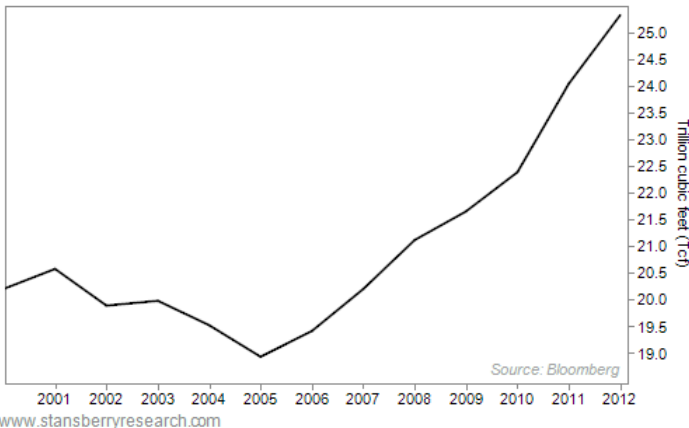
And as bearish as we are on the stock market in general, we believe investing in the explosive growth of the domestic energy sector today will lead to huge gains over the next several *decades*. This is without a doubt *the most important investing opportunity of our lives*.

As we see it today, this ongoing energy boom isn’t just one revolution in the energy industry... it’s three.

Longtime *Investment Advisory* subscribers know the roots of America’s new energy boom lie in drilling technologies – notably hydraulic fracturing (fracking) and horizontal drilling – first developed in the early 2000s by wildcatters working in Texas’ Barnett Shale.

By 2006... the technologies to crack open the dense shale rock and hold it open to release the immense volumes of gas trapped inside were deployed in gas fields around the country. As you can see in the following chart, this created a dramatic spike in domestic gas production...

U.S. Natural Gas Production



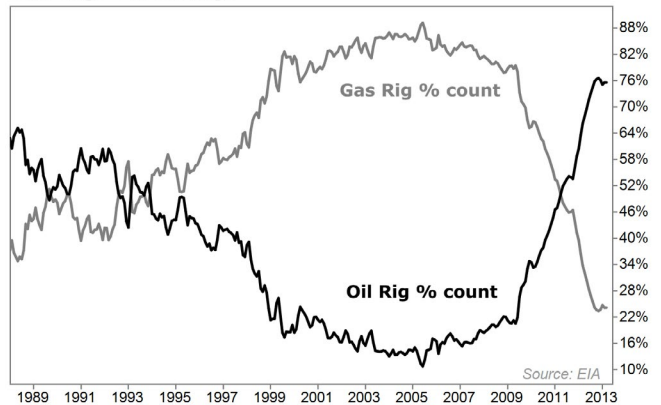
This was the First Shale Revolution – the boom in natural gas production.

The resulting glut in natural gas supplies caused the price to collapse. In October 2005, natural gas traded in the U.S. for an average of \$13.42 per million British thermal units (Btu). By September 2006, less than a year later, natural gas sold here for less than \$5 per million Btu. And except for a short spike higher in mid-2008, natural gas prices have languished at less than \$5 per million Btu ever since. (It’s currently trading for about \$3.32 per million Btu.)

At the same time that the price of natural gas was approaching historic lows in the summer of 2008... the price of oil was soaring to historic highs of more than \$130 a barrel. Domestic drillers naturally turned

their attention to the more valuable commodity. As you can see in the following chart, they shifted all the new equipment that had been looking for natural gas to finding and extracting oil.

Gas Rigs vs. Oil Rigs



The shift to shale oil production, beginning in 2008-2009, led to the Second Shale Revolution.

Oilfield-services firm Baker Hughes reports 1,776 rigs are currently working on U.S. soil. As the chart above shows, an incredible 80% of these rigs are chasing oil. Only 20% (355) are after natural gas. Less than a decade ago, 85% of land-based rigs were chasing natural gas and just 15% were after oil.

These 1,400 oil-drilling rigs are incredibly effective at finding oil, thanks to technologies like seismic mapping and horizontal drilling. They drill productive wells about 75% of the time. That’s a massive change to the oil business, where historically drillers were lucky to have a 25% success rate.

Since 2008 – when the U.S. produced 1.8 billion barrels of oil – domestic petroleum production has spiked 30%, reaching 2.4 billion barrels in 2012.

Neither of these shale revolutions is over. It will take three to five more years of intense drilling in shale beds to eliminate our dependence on foreign oil. And even though it’s illegal for U.S. companies to export crude oil, we can legally export refined products. So by 2020, the U.S. will be a significant supplier of gasoline and jet fuel to the rest of the world.

These new shale oil finds also contain natural gas resources. This so-called “associated gas” comes out of the same wellheads and is a byproduct of oil production. That’s why gas supplies continue to grow, despite the big decline in gas-specific drilling.

So the U.S. will continue to produce a glut of natural gas. Until, that is, the infrastructure is in place to liquefy and transport that gas to foreign markets, where the liquefied natural gas (LNG) commands prices two and three times as high as it does domestically.

This developing market for U.S. energy surpluses is the Third Shale Revolution. And we believe it's the best place for investors to seek out huge profits today.

The Propane Gambit

The best opportunity right now across the U.S. energy complex is in natural gas liquids (NGLs), specifically propane. We've written several times in the past about these opportunities. But for new readers, a few critical facts are important to know and worth repeating here.

In nature, propane is the third most common hydrocarbon, behind methane and ethane. That means, there is a lot of this stuff inside U.S. shale fields. Already the energy equivalent of roughly 20 billion barrels of oil has been discovered inside known U.S. shales. That's roughly five times more energy than was ever produced at the largest U.S. oilfield in history, East Texas.

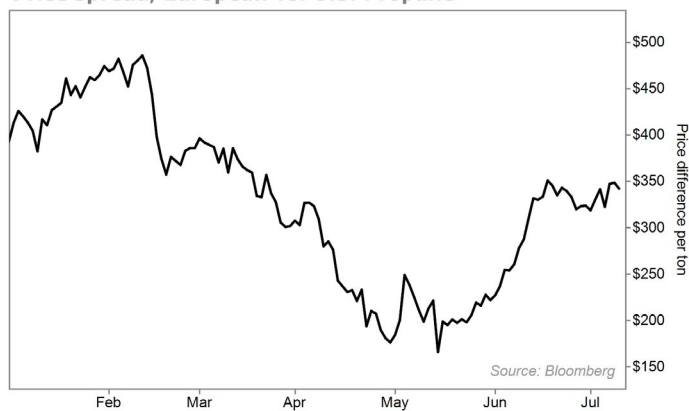
Because of its abundance, its utility as an energy source, and the laws currently governing the export of energy from America... **propane is the key fuel today in the Third Shale Revolution.** It burns like natural gas. You can transport it easily, like gasoline. And most important, no legal barriers prevent U.S. producers from exporting propane to foreign energy markets.

The First Shale Revolution – massive new supplies of natural gas – triggered widespread energy switching. As natural gas prices fell, using natural gas in place of oil and propane became very attractive. This switching to gas greatly reduced domestic demand for propane, lowering its domestic price.

In the rest of the world, though, propane is still very expensive – almost as expensive as crude oil on an energy-equivalent basis. Even if you account for shipping costs, U.S. propane is still a bargain compared with its prices in northern Europe, Korea, or Japan.

For example, look at the current spread between the prices of propane leaving port in Texas with its shipping fully paid versus propane arriving in port in France... The higher the line on this chart rises, the more expensive propane is in Europe compared with the United States.

Price spread, European vs. U.S. Propane



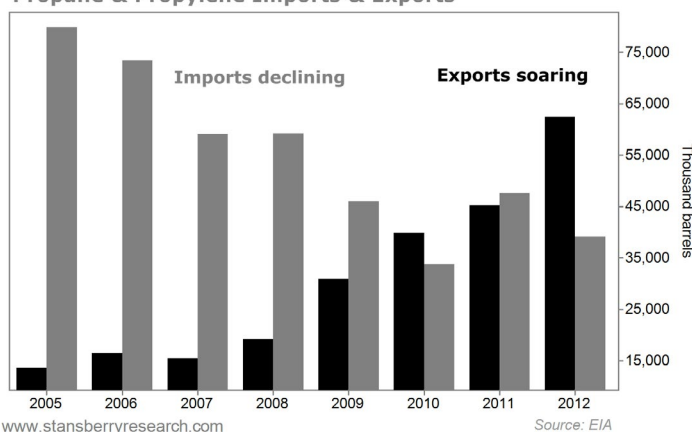
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These prices are quoted in shipping tonnage. There are roughly 288 gallons of liquid propane in a ton. So when the gap between U.S. and European prices is \$250-\$300 a ton – counting the cost of transit – that's roughly \$1 per gallon. Multiply that by as many surplus gallons of propane that the Third Shale Revolution allows. That's a bonanza in the making.

Yet most investors don't realize this Third Shale Revolution has even started.

At first, as shale propane entered the global market, it just replaced U.S. imports. For decades, we have imported propane from Canada, South America, and the Middle East. But the U.S. became a net exporter of propane in 2010. And since then, U.S. exports have skyrocketed:

Propane & Propylene Imports & Exports



www.stansberryresearch.com

Source: EIA

This same analysis is what drove our earlier propane recommendations. We recommended **Targa Resources Corp. (NYSE: TRGP)** in the December 2012 issue, "The New Politics of Energy: How the Insiders Will Get Rich," because it controls critical transport capacity to get domestic propane to foreign markets. That recommendation is up 41% in eight months. We believe it will prove to be one of the best recommendations in the history of this letter.

We recommended **Oneok Inc. (NYSE: OKE)** in April for the same reasons... and that position is up 7% in four months. More important, that company is significantly restructuring in order to focus on the opportunity in propane.

This month, we are recommending yet another way to invest in this trend – by investing in **Energy Transfer Equity (NYSE: ETE)**.

Energy Transfer Equity – through its subsidiary companies – owns a vast network of natural gas and NGL processing, storage, and transport facilities. It sells natural gas to electric utilities, independent power plants, local distribution companies, industrial end-users, and other marketing companies.

But as we'll explain... like Oneok... Energy Trans-

fer is divesting a lot of its business geared to domestic markets and is aggressively building its capacity to sell propane and other NGLs to lucrative foreign markets.

Energy Transfer Equity controls three key subsidiaries: Energy Transfer Partners (NYSE: ETP), Regency Energy Partners (NYSE: RGP), and Sunoco Logistics Partners (NYSE: SXL). The relationship between these companies is complex. These subsidiaries are structured as “master limited partnerships,” and Energy Transfer Equity controls the general partner. Essentially, the subsidiaries run a vast array of pipelines and processing facilities... and Energy Transfer Equity gets a significant cut.

Our investment thesis for Energy Transfer Equity is simple and will sound familiar if you’ve been following our work on propane over the last several months. Energy Transfer is poised to make \$1 per gallon on all of the propane it can export to Europe or Asia. By our estimates, this opportunity is measured in billions per year, with more growth planned.

To explain all this, let’s start with one of Energy Transfer Equity’s subsidiaries, Regency Energy Partners.

By early 2013, Regency owned almost half of the gathering pipes and the natural gas compressors in the Permian Basin, a key energy-producing region of Texas. The other half was owned by Southern Union Gas Service (“SUGS”). But Regency just bought SUGS in April for \$1.4 billion. Now, the two gas-service providers are linking their networks. Energy Transfer will own essentially all of it.

Besides its gathering pipelines in the Permian, Regency also has interests in large pipelines that transfer gas and natural gas liquids from the production areas in the Permian Basin to distribution sites near Houston. Here natural salt domes are used as vast underground storage depots for much of the U.S.’s natural gas, propane, and butane supplies.

But for new investors, we believe it’s Regency’s newest venture that matters the most – Lone Star.

Lone Star is a Houston-based fractionator. (That’s a chemical factory that separates NGLs into purer forms of ethane, butane, propane, and natural gasoline.) It currently refines 100,000 barrels of NGLs per day. A major expansion is underway and will add another 100,000 barrels a day by the end of 2013.

Regency has a 30% stake in Lone Star. The other 70% is owned by Energy Transfer Partners, which is owned and controlled by the parent company, Energy Transfer Equity.

Many investors are interested in owning units of these subsidiary master limited partnerships, which trade publicly. The attraction is the tax-advantaged income they generate. But we recommend investing in the general partner. We do so because of something called

Incentive Distribution Rights (or “IDRs”). These are big incentives the general partner can earn when the results of the limited partners exceed certain levels.

To see how that works, note Targa Resources Corp. and Oneok have similar relationships with limited partners Targa Resources Partners (NYSE: NGLS) and Oneok Partners (NYSE: OKS), respectively.

Here are the dividend-reinvested returns for those two companies, compared with their limited partners, since July 2011 (an energy bull run if there ever was one).

- OKE (Oneok general partner) – 54% gain
- OKS (Oneok limited partner) – 31% gain
- TRGP (Targa general partner) – 117% gain
- NGLS (Targa limited partner) – 65% gain

Notice the general partners’ returns exceed the limited partners’ by a wide margin. So if you’re bullish on a given limited partner’s prospects – and we’re very bullish on both Regency’s and ETP’s prospects – you should buy the general partner and enjoy the juiced-up IDR bonuses.

Put another way, the limited partners are pure infrastructure plays with steady dividends. But they are shielded from extreme changes in profitability. So they are stable long-term investments. But we know the general partner will outperform the limited partner in boom times for its sector. And there’s never been a boom time like this one for propane...

Lone Star just announced last month that it is connecting its fractionator to a giant former oil-importing port on the Texas-Louisiana border – a \$250 million infrastructure project known as Mariner South.

In addition, Regency is building a “de-ethanizer” to bring its U.S. propane up to international standards. The initial capacity is 60,000 barrels per day. But Lone Star can expand this to meet its needs. Once the second phase of the fractionator is operational, we expect this de-ethanizer capacity to double. And after the Panama Canal reopens for 100% of the propane tanker fleet, we expect export capacity to double again.

The Lone Star joint venture is adding 200,000 barrels per day of NGL fractionator capacity to Regency. Almost all of this 200,000 barrels per day... or 8.4 million gallons per day... would be propane and butane that Lone Star could export.

Despite this vast throughput, neither ETP nor Regency is in the port-operations business.

So Lone Star turned to the experts at Sunoco Logistics, which has decades of experience with oil and propane shipping. And of course, Sunoco Logistics has the same general partner as ETP and Regency: Energy Transfer Equity. So the division of ownership for the Mariner South propane export terminal hardly matters – investors in ETE always win.

Energy Transfer Equity Easing Off Domestic Business

Houston, Pennsylvania is in the heart of a fourth major U.S. shale play, the Marcellus. Houston is not in the geographic center, mind you. But it's right where the NGLs are richest.

Sunoco Logistics is building two pipelines out of Houston: Mariner West takes ethane up to Sarnia, Ontario on the Canadian border, where it supplies major rubber and plastics manufacturing plants. Mariner East takes propane to Philadelphia, where Sunoco owns a deep-water port. Mostly, these Mariner projects piggy-back on existing pipelines. So Sunoco's entry costs and timelines are much less than any rival.

Industry sources tell us that's why Energy Transfer Equity bought Sunoco last year – to get these large cross-country NGL pipelines. Just as important, the general partner is selling off its domestic propane distribution business. Its focus is on taking advantage of the gap between U.S. and world propane prices.

The first sign of this shift was when ETP sold a company called Heritage Propane to Amerigas Partners (NYSE: APU) in October 2011. The Heritage Propane deal was for \$2.8 billion, which Amerigas paid half in cash and half with shares. Last month, ETP sold 7.5 million of its APU shares, netting \$350 million.

Why does this matter? The current chairman of Energy Transfer Equity and Enterprise Transfer Partners, Kelcy Warren, was the past president and CEO of Heritage Propane. Arguably, nobody knows the domestic propane distribution business better. Yet his Dallas-based brain trust is selling its Amerigas shares as fast as it can. It's raising capital to pay off debt, expand its propane export terminals, and build its newly approved liquefied natural gas (LNG) terminal. His money is not in keeping the propane or natural gas here... it's in selling cheap U.S. fuel to the world.

Energy Transfer Equity owns IDRs for both Regency and ETP. Further, ETE receives the IDRs from Sunoco Logistics, which flow through ETP to ETE. By getting alongside the general partner, we'll enjoy the growth of all three limited partners.

In addition, we expect Energy Transfer Equity to create an international trading business to purchase domestic propane and export this to Europe and Asia. ETE and its subsidiaries are spending billions of dollars on NGL infrastructure, while divesting from the domestic propane distribution business.

The company's 2012 annual financial statements showed Kelcy Warren owns 16.1% of ETE's common shares. CFO John McReynolds owns 2.3% with the

directors and executives as a group owning a total of 18.8%. We love investing alongside owner-operators because their interests align with ours.

As we mentioned above, investing with the general partner allows investors to amplify their returns during boom times. It's worth noting that Warren and McReynolds are on the boards of both Energy Transfer Equity (the general partner) and Energy Transfer Partners (the limited partner). **These men know the prospects of both companies better than anyone, and their personal wealth is currently invested in ETE.**

Something else to keep in mind is the additional way the general partner gets increased income. You see, since limited partners are often MLPs that can't retain earnings, they rely on growth by issuing additional units (shares). Since IDRs entitle the general partner to a certain percentage of all cash generated, the bigger the limited partner becomes, the bigger the IDRs grow. For example, if a limited partner finances a bunch of expansion with equity, then the general partner reaps an outsized portion of the fruits of expansion.

Granted, if the limited partners struggle to grow income or if debt-servicing eats into profits that would normally flow through to the general partner, it too will suffer. That is why we suspect some of the profits from international propane sales will flow back through to the limited partners to pay off the debt for their multi-billion-dollar infrastructure investments, which includes the purchase of Sunoco Logistics.

ETE itself also has significant debt. At least initially, a reasonable chunk of its profits that the company will earn through propane exports will be used to service or retire its own debt. The rest will be retained or paid out to shareholders in dividends.

By the numbers, ETE's market cap trades for around \$18.5 billion today. Its enterprise value (EV) – that is its market cap plus debt minus cash – is about \$56 billion. That includes \$22.8 billion in debt, \$15.6 billion in minority interests, \$73 million in preferred equity, and \$621 million in cash. (Minority interest is the amount the company shows on its balance sheet as a liability for the pieces of any businesses it doesn't control.)

Between debt maturities and interest payments due, the company's consolidated contractual obligations include around \$7 billion due over the next three years, another \$7 billion in three to five years with the remaining maturities spread out beyond five years.

The company's total assets as of March 31 were a

Energy Transfer Equity Fundamentals				
Amounts in \$MM				
	2012	2Q 2013	2013	2014
For the period ending	12/31/2012	6/30/2013	12/31/2013	12/31/2014
		current/LTM	Est	Est
Market cap.	\$12,732	\$18,592	-	-
Enterprise Value	\$48,723	\$56,422	-	-
EV/EBITDA	21.8	18.1	14.5	13.0
Price/Cash Flow	11.3	10.5	9.6	8.0
Price/Sales	0.7	0.5	0.4	0.4
Dividend Yield	5.5%	3.8%	4.0%	4.4%
Return on Equity	27.9	15.9	23.4	29.7
Sales	\$16,964	\$36,726	\$46,188	\$46,827
EBITDA	\$2,231	\$3,111	\$3,902	\$4,356
Cashflow-Operating	\$1,078	\$1,781	\$1,847	\$2,217
Total Assets	\$48,904	\$50,143	-	-
Cash & Equivalents	\$372	\$621	-	-
Total Debt	\$22,053	\$22,759	-	-
Preferred Equity	\$73	\$73	-	-
Minority Interest	\$14,237	\$15,619	-	-

Source: Bloomberg
Est = Bloomberg estimates
LTM = Last 12 months

bit more than \$50 billion. That's just 10% shy of where its EV sits today. Property, plant, and equipment made up just a little more than \$29 billion.

Sales last year for ETE totaled \$17 billion. Earnings before interest, depreciation, and amortization (EBITDA) were \$2.2 billion. The company just booked \$962 million in EBITDA for the second quarter ending June 30. With the company's acquisitions and growth potential we've outlined, we expect we'll see those figures increase dramatically over the next few years.

And this is where valuation gets interesting for us today. For example, Bloomberg's consensus estimates put ETE's 2013 revenues at \$46 billion, EBITDA at \$3.9 billion, and operating cash flows of \$1.8 billion. Those are 175%, 50%, and 68% higher than 2012 numbers, respectively.

As you can see in the table above, estimates put the company's EV/EBITDA at 15.5 by the end of this year, down from the current 18. Next year's estimates put that ratio even lower, at 14.5. Likewise, its price to operating cash flows drops from 10.4 today to a little more than eight for fiscal 2013.

Those are solid multiples, but we think ETE's upside is much better than that. ETE is bringing online propane-processing capacity equal to 220,000 barrels per day. That's 9.2 million gallons of propane available for export each day. At roughly \$1 per gallon in profit after shipping costs (the difference between U.S. and

European gas prices), that's \$3.4 billion more in net profit per year... and even if \$1.5 billion of this new annual profit goes to the three subsidiary limited partners, there's \$2 billion more in EBITDA left for ETE.

Even if shares rise to \$75, that would represent a dirt-cheap EV/EBITDA ratio of 8. And if the market maintains the ratio in the mid-teens, our gains would be even greater.

We believe this is where the real value lies... in its tremendous growth potential. And that's why we want to buy today.

Action to take: Buy Energy Transfer Equity (NYSE: ETE) up to \$75 a share. Please use a 25% trailing stop.

SIA Indicators

Over the past couple of months, the SIA Spread Signal has been giving us bearish signs.

We follow the spread because it shows us how corporate bondholders feel about the overall market and global economy. The amount of credit available in the economy has a huge impact on asset prices. The world's bond markets are vastly larger than the world's stock markets. Thus, credit tends to be the main driver of both bull and bear markets.

When credit is cheap and widely available, specula-

tors can easily use credit to bid up asset prices. Thus, cheap credit typically correlates with market tops. Likewise, when credit is hard to get and expensive, asset prices usually will form bottoms.

The best way to measure the availability and price of credit is to compare various interest rates with the 10-year U.S. Treasury bond yield. The *SIA Spread* is simply the difference between interest rates on higher-risk bonds and the interest rate on the world's benchmark rate, the 10-year U.S. Treasury bond.

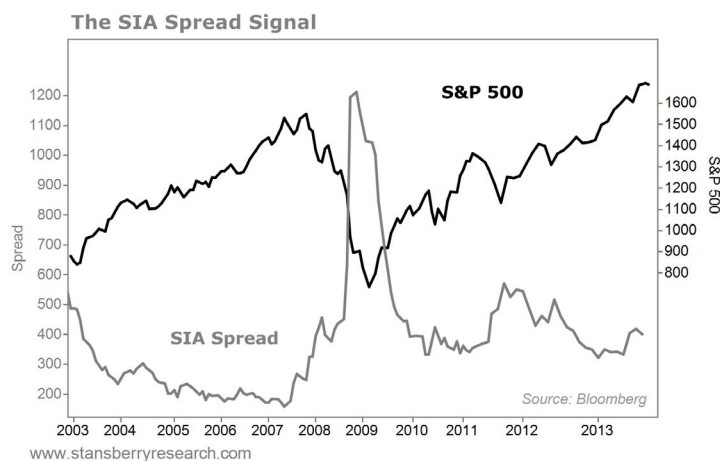
When the spread widens, the gray line on the chart (below) rises. That tells us that corporate bond buyers are seeing more risk in the market and are demanding higher interest payments. This is negative for stocks, as credit costs more for companies.

The black line in the chart plots the S&P 500.

As we've said before, our indicators are contrarian. We use them to measure extremes in the market. When the gray line heads lower, investors are more confident, which in turn sends stock prices higher. Likewise, when confidence fades and risk returns to the market, the gray line rises and stocks tend to fall.

While for now the S&P 500 continues its trend upwards, the spread signal is sending us warnings.

SIA Spread Signal: Bearish



Now let's look at our *SIA Money Flows Gauge*.

Since January, we've seen investors pour billions into stock-based mutual funds.

During the first six months of this year, we've seen an average of \$15 billion flow into mutual funds each month. Net inflows are shown in the chart by the gray line.

Like our Spread Signal, the Money Flows Gauge is a contrarian indicator.

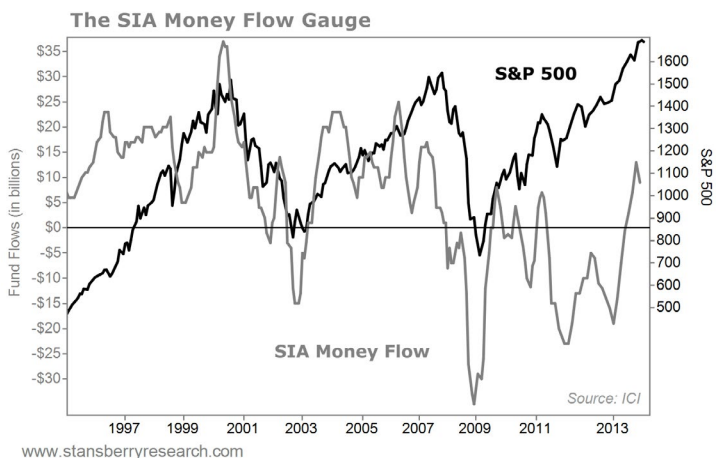
When it's at extremes like we saw in March 2009 and investors were selling in droves, that's when we want to be buyers. That's when we'll find the most bargains.

Likewise when it's rising to extreme levels at the top of the chart, it means investors are piling in and pushing stock prices higher as indicated by the black line in the chart. That makes it more difficult for investors like us to find stocks at reasonable prices... let alone cheap.

It's true that money flows aren't at the crazy levels seen back in 2000 just before the crash. Nor quite the heights we saw in 2006 and 2007. But as we pointed out last month, money flows are now at levels that we believe warrant attention.

While investors may continue to push stocks higher, the money flows gauge at these levels is urging caution.

SIA Money Flows Gauge: Bearish



Our third indicator is the *SIA Black List* (see p. 14), which tells us when investors become greedy.

This is our list of stocks with a market cap more than \$10 billion that trade for more than 10 times sales. Paying this much for any business is crazy in our view... especially for companies with huge market caps.

The names on the list don't matter. We don't use the list to find short plays, as we never short just on valuation.

We use the list to gauge risk in the markets. When more than 10 names appear on the list, we think investors are paying excessively for stocks and have lost touch with reality. They're no longer buying based on valuation. They're simply chasing stocks higher, which pushes them to ridiculous prices.

Today, we have 15 companies on the list. That's four more than last month and sends us a massive warning.

SIA Black List: Bearish

Our indicators are telling us we're in tough terrain to enter new long positions in the broader market. We need to be careful we don't overpay for stocks. We don't want to buy at the top. And we consider it prudent to add to the short side to hedge our portfolio.

August 2013 SIA Black List						
Ticker	Name	Market Cap	P/S	Price	P/E	Total Return YTD
MA	Mastercard	77,961,805,824	10	646	27	32
FB	Facebook	64,042,795,008	15	39	169	46
CELG	Celgene	58,668,519,424	10	143	32	82
BIDU	Baidu	47,334,981,632	11	135	28	35
PSA	Public Storage	27,980,390,400	14	163	36	14
LNKD	Linkedin	25,705,986,048	20	233	664	103
REGN	Regeneron Pharmaceuticals	25,274,757,120	14	253	55	48
ALXN	Alexion Pharmaceuticals	22,420,725,760	17	115	67	22
VRTX	Vertex Pharmaceuticals	18,171,000,832	13	78		86
AVB	AvalonBay Communities	17,109,650,432	12	132	68	-1
TSLA	Tesla Motors	15,981,946,880	14	134		296
COG	Cabot Oil & Gas	15,952,750,592	11	76	73	52
WDAY	Workday Inc	12,528,307,200	18	73		33
TRIP	Tripadvisor	11,181,505,536	13	78	52	86
YNDX	Yandex	10,778,944,512	11	33	37	52

Portfolio Update

As the bull market ran to historic highs, almost all of our long positions picked up at least 3%-5% this month. Unfortunately, that also meant our short positions suffered. As we go to press, **Salesforce.com (NYSE: CRM)** is near our trailing stop, and we continue to monitor the position closely.

While the shorts have gone against us so far, we continue to recommend you hedge your portfolio with short positions. We are making plenty of money on the long side, and you should view your shorts as a form of “portfolio insurance”...

All six of our property and casualty (P&C) insurance picks released second-quarter earnings this month... and all six beat expectations. We have been closely monitoring how our P&C picks behave during periods of rising interest rates. The market seems scared of insurance companies during periods of rising rates. As we’ve explained before, this concern makes sense for life insurers, but not P&C insurers. In the April 30 edition of *Stansberry Data*, we noted:

Even W.R. Berkley – which has chosen to eschew equities altogether and is 93% exposed to fixed income – has MUCH less interest-rate exposure than a life insurer. The average duration of a WRB fixed-income investment is just 3.4 years. An interest-rate move of 300-plus basis points (i.e., 3%) would only result in a 10% hit to WRB’s portfolio value.

Bill Berkley would gladly trade a 10% shift in his “investments” account for the opportunity to invest in higher-rate securities.

Right on cue, on his second-quarter earnings call, Bill Berkley spoke for himself... (emphasis added)

Clearly, if we have a 65 or 75 basis point [0.65%-0.75%] increase in rates given the short duration of our portfolio in new cash flow, our rising investment income would very quickly offset that... We have a relatively short-duration portfolio. It’s about... 3.3 years... **We think the positive impacts on [rising rates] in our business would be much greater than the negative impact of inflation (rising rates) on our bond portfolio.**

Our oil and gas producer **WPX Energy (NYSE: WPX)** – which discovered the natural gas “gusher” we described in the May issue – has made another significant discovery.

And this time... it’s oil.

The company has 31,000 net acres in the Gallup Sandstone, which is part of the San Juan Basin in the U.S. Southwest. WPX has drilled four successful wells that indicate the company could have as much as 66 million barrels of oil equivalent there. WPX estimates approximately 70% of the reserves are oil. The company plans to drill between eight and 10 more wells during 2013... three are already in progress. They expect these wells to produce 3,400 barrels of oil equivalent per day

by the end of this year.

This is fantastic news for the company. It has extensive knowledge and experience in San Juan, with around 159,000 net acres under lease.

The company is also expanding its operations in the Piceance Niobrara discovery in Colorado we described in the May issue. This is the natural gas gusher that produced 1.4 billion cubic feet of gas in its first 180 days. The company is adding additional rigs and implementing pad drilling, which improves drilling efficiencies.

The company recently announced an \$18 million net profit for its second quarter. For the same period last year, the company booked a \$10 million loss.

WPX has superb assets. We've said before, this company's management, led by Ralph Hill, constantly talks about financial performance. It targets operational efficiencies and returns on capital for shareholders. These are not common traits found in the resource sector. We believe this team is among the best to execute effectively on its newfound and growing asset base. **WPX is a buy up to \$25 per share.**

Meanwhile, shares of our natural gas transport recommendation **Oneok (NYSE: OKE)** bounced about 30% off their July lows of around \$40.

In last month's issue, we covered OKE's plan to sell its Energy Services business. The market didn't like the news, and shares had sold off from more than \$50 to around \$40 in early July. But as we said at the time... we saw it as a good move for the company. We encouraged readers to hold on to their positions and saw the sell-off as a good buying opportunity.

Since then, the company announced plans to spin-off its natural-gas-distribution business into a separate publicly traded company. The new company, One Gas, will trade on the NYSE under the symbol "OGS."

And the markets loved the news. Shares popped roughly \$10 higher in one day.

One Gas will serve more than 2 million customers across Kansas, Oklahoma, and Texas with its headquarters in Tulsa.

The deal looks set to give shareholders higher dividend payouts. Oneok expects to raise its dividend once the spin-off is complete. Plus, it expects One Gas will pay a dividend in line with other natural gas utility peers. Chairman John Gibson reiterated this on the company's recent earnings call.

When we went to press last month, our Oneok position was showing a double-digit loss. Since the turnaround, we're now enjoying 7% profitable returns. **Oneok remains a buy.**

Our video-game producer **Activision Blizzard (Nasdaq: ATVI)** received a boost this month when the

company and a consortium led by CEO Bobby Kotick and co-chairman Brian Kelly agreed to buy the bulk of shares currently held by Vivendi. According to the proposal, Activision will buy 429 million shares for \$5.8 billion, while the consortium ASAC II LP will purchase 172 million shares. Vivendi will hang on to about 12% of the stock. Activision expects the deal to close by the end of September 2013.

The market clearly liked this deal. Shares jumped from a little over \$15 to over \$18 when the company announced the deal. **We're currently enjoying around 38% gains so far and continue to recommend the stock as a buy.**

The company posted more than \$4.8 billion in sales last year, producing a \$1.1 billion net profit and \$1.2 billion in free cash flow.

Upside potential for our telecommunications giant **Ericsson (Nasdaq: ERIC)** continues to impress. Russia looks set to spend up to \$13 billion to boost speeds on its mobile network. Ericsson has the inside track since it's the undisputed market leader and already has contracts in the giant Eurasian country. Engineers have been installing 4G antennas and transmitters on buildings near the Kremlin to develop a new 4G network in Moscow. You see, most of Russia still doesn't have the 3G or 4G quality that the rest of Europe takes for granted. This is exactly what we predicted in October 2012:

Only 4G LTE technology allows HD Voice. It does so by radically increasing the amount of bandwidth available to each subscriber... Most people don't realize what's going to happen to total network traffic as each handset becomes much faster. Think of the difference between a garden hose and Niagara Falls. Then, multiply that by millions of users in each developed country.

When the "developed country" happens to be Russia... there's a ton of profitable build-outs for the world's market leader. As Ericsson's Robert Puskarić put it: "Russia has a lot of potential when it comes to mobile broadband.... There is still so much to do." We're up about 48% so far on Ericsson, which is currently a "hold" in our portfolio.

Regards,



Porter Stansberry with
Brett Aitken, Bryan Beach, and Dave Lashmet
August 15, 2013

Stansberry's Investment Advisory Model Portfolio

Prices as of August 14, 2013

	Symbol	Ref. Date	Ref. Price	Recent Price	Dividends	Description	Action	Return*	Risk	
"No Risk"										
	Johnson & Johnson	JNJ	07/06/06	\$60.52	\$90.70	\$14.13	World Dominator	Hold	73.2%	2
	Wal-Mart	WMT	09/09/10	\$51.91	\$76.40	\$4.77	World Dominator	Hold	56.4%	2
The "Next Boom"										
	Activision Blizzard	ATVI	10/13/11	\$12.92	\$17.44	\$0.37	Gaming Publisher	Hold	37.8%	2
"Sensory Masters"										
	Dolby Laboratories	DLB	08/10/12	\$34.47	\$32.74	\$4.00	Audio Technology	Hold	6.6%	2
	Corning Inc	GLW	09/13/12	\$12.63	\$15.12	\$0.28	Glass Technology	Hold	21.9%	2
	Ericsson	ERIC	10/11/12	\$8.61	\$12.33	\$0.43	LTE Network	Hold	48.2%	2
	EMC Corp	EMC	01/10/13	\$23.85	\$26.78	\$0.10	Cloud Storage	Hold	12.7%	3
Energy Renaissance										
	Dominion Res.	D	07/18/11	\$48.00	\$58.86	\$4.22	Export LNG	Buy	31.4%	2
	Chicago Bridge & Iron	CBI	06/07/12	\$35.97	\$60.40	\$0.25	Energy Infrastructure	Buy	68.6%	2
	Devon Energy	DVN	08/17/12	\$58.97	\$57.95	\$0.82	Shale Play	Buy	-0.3%	2
	Teekay LNG Partners	TGP	11/17/11	\$32.72	\$42.70	\$4.68	LNG Tankers	Hold	44.8%	3
	Targa Resources Corp	TRGP	12/13/12	\$48.46	\$66.96	\$1.49	Propane Export	Hold	41.2%	3
	Westport Innovations	WPRT	01/10/13	\$27.93	\$28.20		Natural Gas Engines	Buy	1.0%	3
	ONEOK	OKE	04/11/13	\$48.60	\$51.25	\$0.74	Propane Export	Buy	7.0%	3
	WPX Energy	WPX	05/10/13	\$17.12	\$18.42		Natural Gas Production	Buy	7.6%	3
	Energy Transfer Equity	ETE	08/14/13	NEW	\$65.63		Propane Export	Buy	NEW	3
"Trophy Assets"										
	Union Pacific	UNP	01/19/12	\$112.18	\$158.59	\$3.87	Trophy Railroad	Hold	44.8%	2
The World's Most Capital-Efficient Companies										
	Hershey	HSY	12/06/07	\$40.55	\$96.09	\$7.44	World Dominator	Hold	155.3%	2
	Microsoft	MSFT	02/09/12	\$30.77	\$32.35	\$1.52	Tech Giant	Hold	10.1%	2
	McDonald's	MCD	12/13/12	\$89.17	\$96.11	\$1.54	Burgers	Hold	9.5%	2
Property & Casualty Insurance – "The World's Best Business"										
	W.R. Berkley	WRB	03/15/12	\$35.85	\$42.26	\$1.54	Blue-Chip Insurance	Hold	22.2%	2
	American Financial	AFG	10/11/12	\$38.11	\$52.42	\$0.84	Blue-Chip Insurance	Hold	39.8%	2
	Travelers	TRV	10/11/12	\$69.16	\$82.18	\$1.42	Blue-Chip Insurance	Hold	20.9%	2
	Chubb	CB	10/11/12	\$77.72	\$85.90	\$1.29	Blue-Chip Insurance	Hold	12.2%	2
	Alleghany	Y	10/11/12	\$350.50	\$404.16		Blue-Chip Insurance	Hold	15.3%	2
	Navigators	NAVIG	10/11/12	\$52.25	\$56.31		Blue-Chip Insurance	Hold	7.8%	2
Pairs Trade										
	Chesapeake Energy	CHK	07/11/13	\$21.29	\$24.91		Oil & Gas Exploration	Hold	17.0%	3
	Suncor Energy	SU	07/11/13	\$31.72	\$32.72		Expensive Oil Sands	Sell Short	-3.2%	4
	<i>Combined Position</i>		07/11/13						6.9%	
	Sears Holdings	SHLD	08/14/13	NEW	\$41.73		Speculative	Buy	NEW	4
	J.C. Penney	JCP	08/14/13	NEW	\$13.11		Obsolete Retail	Sell Short	NEW	4
	<i>Combined Position</i>		08/14/13						NEW	
Victims										
	Canadian Oil Sands	COS.TO	09/13/12	C\$21.37	C\$20.48	C\$1.05	Expensive Oil Sands	Sell Short	-0.7%	4
	Salesforce.com	CRM	06/13/13	\$37.80	\$44.66		Options Abuse	Sell Short	-18.1%	4
	iShares US Bond	TLT	01/19/12	\$118.32	\$105.15	\$5.08	Failing Currency	Sell Short	6.8%	5
<p>* Returns include dividends. Stansberry's Investment Advisory's Model Portfolio does not represent any actual investment result. Our reference price represents the price of our recommended securities at the time we wrote the recommendation. Please note: Our investment philosophy requires limiting risk through the use of trailing stop losses. Unless otherwise noted, all recommendations use a 25% TRAILING STOP LOSS. NEVER ENTER YOUR STOPS INTO THE MARKET. KEEP SUCH INFORMATION PRIVATE. In the Stansberry Investment Advisory, we use protective stop losses. We'll update you in our monthly issue when these stops are hit. But if you're following our recommended stops, it's your responsibility to keep track of them and take action in a timely manner. How to use a trailing stop: A stop loss is a predetermined price at which you will sell a stock in case it declines. A "trailing stop" is a stop loss that "trails" a stock as it rises. For example, let's say you set a 25% trailing stop on a stock you purchase for \$10. If the stock rises to \$20, you would move your trailing stop to \$15 (\$5 is 25% of \$20, \$20 - \$5 is \$15). Only use closing prices, and never enter your stop into the market. For more information, see our frequently asked questions at www.stansberryresearch.com/secure/faq.asp. Our risk label is based on current share price and one-year business outlook. 1 = the lowest possible risk. 10 = the highest possible risk.</p>										

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