
The Market They Love To Hate And The One That They Might Hate That They Loved.

Investors hate stocks when they own them and they go down. Investors also hate stocks that go up when they don't own them. Most investors have a history of getting excited about stock sectors or world regions right after they've been strong and get very negative after a number of years of poor price performance. The second half of 2007 is a time of knowing which stocks and sectors are hated (out of favor) and which ones are receiving affection late in a positive cycle.

One of my favorite "golden rules" is that the stock market will do whatever it has to do to frustrate the most people. Right at the moment these frustrations are connected to record highs by the Dow Jones Industrial Average and the S. and P. 500 Index. These new highs are being led by the largest capitalization companies in the U.S. Why is it a source of immense frustration to investors? Most investors (retail and institutional) have spent the last 7 years selling out of those same company shares.

Over the last 12 months the two best performing Dow stocks and two of the heaviest hitters (prominent stocks) in the S. and P. Index were Merck (MRK) and American Telephone and Telegraph (T). They've both gained over 50% in the last twelve months. What did they have in common a year ago? First, they had zero outright buy recommendations from security analysts on Wall Street and almost no major money managers or mutual funds owned them in their top 20 holdings. Second, their stock price had fallen by more than 50% in the prior six years. Third, they were trashed in the major media. Lastly, they sold for low price-to-earning ratios and offered high dividend yields.

Most investors hate MRK and T because they don't own them and they have recently performed well. They also hate them because they will be a solid place to be for many years because they are under-owned by most stock market participants and have bright futures even in a period of slow economic growth. Who doesn't get their prescriptions filled in an economic downturn or cancels cellular phone service while unemployed? These two companies are very representative of the sector which I think will provide the best returns the next three to five years, **large cap quality**. The company that looks the most like MRK and T did last year is Wal Mart, everybody hates it.

Wal Mart has been the subject of a major negative public relations campaign. The campaign's goal is to pressure the company in to unionizing its labor force. It reminds me of McDonald's a few years ago when "Supersize Me" came out and the press made them look like they were trying to kill their customers with high fat content food. It also reminds me of the media and plaintiff lawyers attempting to paint Merck as a company which wanted to sell Vioxx or other drugs which could potentially harm their customers. Being non-union keeps Wal Mart's labor cost down and contributes to lower prices for the customer and is a huge competitive advantage. Despite the campaign, Wal Mart gets hundreds of applications for job openings at their stores and Wal Mart has a huge outpouring of applications when they open for business in a new town. When your company gets attacked, investors and institutions sell out or avoid your stock. McDonald's has had a big move up in stock price since the "Supersize Me" movie came out and I wouldn't be surprised to see

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Wal Mart's stock be a good performer in the next three years.

Who do they love now that they will hate later? Today's investor infatuation is Emerging Market/International Investing. We've talked many times about the mentor to former Intel CEO Andy Grove who taught him that "when everyone knows something is so, nobody knows nothing." What everyone knows is that emerging economies like China, Russia, India and Brazil are growing rapidly and that we are foolish if we don't participate by owning mutual funds and exchange traded funds focused on those markets. U.S. investors have put more into International Emerging markets in the last two years than they did the prior 10 years.

In both 2005 and 2006, \$180 billion of U.S. investor capital went into equity mutual funds. Of that, \$150 billion went into International equity funds. This is not normal. Normal would be more like 90% domestic and 10% foreign. History is littered with debacles that came to investors by getting excited about growth halfway around the world and sending their money to chase it. The Netherlands Tulip Mania of 1636, the South Seas Bubble of 1720 and foreigners chasing Technology stocks here in 1998-1999 are just a few examples.

The current equity mutual fund flows I mentioned are very similar to the affection technology heavy mutual funds received in 1998 and 1999. Do you hear the rhyme? History teaches us to be concerned about parabolic price increases in illiquid markets. It also teaches us to not trust human nature when it is combined with non-democratic governments. As I have mentioned in my recent newsletters and lectures, asset allocation has contributed to a great deal of additional interest in international investing. There is nothing inherently wrong with international investing, it is just that it is ridiculously popular currently and therefore over priced and over admired by market participants.

While investors have flooded the Emerging/International sector with money the

last three years, they've spent the same time liquidating large cap growth funds. For five years in a row the large cap growths funds have seen net sales in aggregate (in a world of 401k automatic contributions that is amazing). It is the longest streak of net selling that a mutual fund sector has had in the last 40 years. Prior to this stretch, a three-year stretch was considered wandering in the desert. This sector currently has historically low price-earnings ratios and high dividend yields in relation to other market sectors. Give me the large cap growth funds that most investors hate today (or rather the large cap growth companies they would normally be buying) and you can keep the Emerging Market/International Investing Funds. If the large quality stocks go from being hated to loved, we could make some very good money. On the other hand, when it comes to chasing Emerging/International, I think that many investors will hate that they loved them.

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