

### **Too much of a good thing can be wonderful**

It's safe to assume that Mae West wasn't talking about the stock market but a good market for Growth stocks can create almost as much bliss.

**Bottom Line:** The current rally has "Growth" stocks and Technology in the lead. We've been parched for outsized gains for much of this decade so don't succumb to the knee-jerk reaction that we're experiencing a short-term blip, as this is probably a longer-term wave lead by Technology similar to 1995 to 1999. As mentioned many times previously, Growth stocks had become as cheap relative to Value not since the 1970's. Adding fuel to the move up in Growth has been the problems associated with Housing and credit, which for the most part don't affect Tech at all but are a real drag on Value. Hence the disparity between Growth and Value this year has been very pronounced. The Russell 2000 Growth Index is now 12.7% YTD, while the Russell 2000 Value Index is up just 0.6% higher, essentially a complete flip-flop from 2006. The macro backdrop for Growth stocks remains the best in years and should continue to remain so for the next 2-3 years.

Despite this positive backdrop and not meaning to sound like an economist talking out of both sides of my mouth, we do need to restrain ourselves and raise some cash. Since Growth stocks move much faster than Value stocks, portfolio turnover does increase and it's smart to raise some cash as markets rise and speculation increases. The ability to raise cash as we have is one very important difference between individually managed portfolios and those of mutual funds that are usually 100% invested 100% of the time.

This most recent catapult in prices was born off the selloff and pessimism in August, now we're reaching a sentiment extreme in the opposite direction: excessive enthusiasm. Lagging stocks, which are a drag on portfolios, are targets for sales along with incremental sales of shares that have risen sharply are candidates as well. This cash can then be utilized once the next inevitable market correction occurs when investor sentiment becomes excessively bearish.

Think back to the last time we had this backdrop of an easing Fed and good valuations: 1995. This was the last up cycle in Growth stocks and the rally lasted till the first quarter of 2000, a very good 5-year period. Impossible to say exactly how long this cycle will endure, but considering this is year one, we could be in store for at least another 2-3 years, or until the Fed decides to throw a cold blanket on Growth stocks, at which point we lighten up.

Just like 1995, this rally is being led by Technology but the names represent the new generation of Growth leaders: Apple, Google, Research In Motion, Gamestop, and Garmin. These are four very strong horses that are breaking free and running up into new territory, to pull back the reins on them at such an early point in the cycle is akin to disbelief in the new Growth cycle, and a sure way to underperform.

Think of it another way, the prices of these stocks in recent years have not kept up with the underlying growth of the companies. Nor have they kept up with the share price growth of much slower companies in industries with very modest and mature growth like insurance or even utilities. Sooner or later, that underperformance had to end and the Growth stock prices would catapult ahead and move to a level befitting their growth rates.

These names all have more than a few things in common too:

1. No exposure to housing or mortgages.
2. Significant international sales, which is necessary with a weak U.S. economy.
3. Tendency for a cleaner/greener profile.

The shift bodes well for the “Green” investor who’s had to weather the bull market in oil and mineral stocks while Green growth companies received littler or no respect. So far this year we’ve seen quite high returns albeit with some losers in the “Green” field; big winners included First Solar, Lulumon, Green Mtn Coffee, Sunpower, and Hanson. Mixed in were misses by two Chinese solar plays: LDK Solar and Trina Solar. For the first time Solar Power is a legitimate and profitable with incredible revenue and earnings growth. It’s probably a bit too hot to handle at the moment but should oil drop in price, we could see a buyable pullback in solar shares.

One thing conspicuously missing from the list of leaders above are the foreign shooting stars like Baidu.com which moved from \$190 to \$349 in a matter of a few weeks. Or America Movil, Credicorp, Banco Itu, Central European Distributors, Vimpel Communications as these are more “trades” than considered investments for the longer term. While its possible that some of our foreign holdings could turn into longer term plays as America Movil has been (200% in two years) the underpinnings of these growth companies could be shaky if foreign markets turn sour at which time they’ll be sold.

To sum it up, this has been a remarkable run and its probably not finished for the year. I believe some caution is in order, as we’d like to keep our gains. Playing the cycles between extreme optimism and pessimism is a wonderful thing when growth stocks are in vogue so expect us to repeat this strategy into 2008.

All the best,  
Brad Pappas

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