## Best Performing Sectors in Bull Markets

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Dear Clients and Prospective Clients:

Paul Lim is a business writer for the New York Times and he had an interesting thesis in his article on July 19th entitled, "Picking Winners in the Next Bull Market". He correctly acknowledged that it would be highly unusual for the leading sector of the previous Bull Market to lead the next one. For this reason, he advised hesitation on an urge to chase the emerging markets and those companies (like oil) which benefitted most from the last bull market. We can give you numerous examples from our 29 years in the investment business which back up his thesis.

From the 1974 low of 550 on the Dow Jones Industrial Average to the 1983 high around 1200, technology companies with fast earnings growth were popular. This wave crested soon after Apple and Genentech went public. Investors wanted fast growth to offset double-digit inflation rates and handed out high P/E ratios to those fast growers. When Paul Volker broke the back of inflation through tight credit and President Reagan stood down the Air-Traffic Controllers in late 1981, the game changed. Inflation began to decelerate and investor interest moved away from these popular names. Technology stocks spent seven to eight years in the dumper during a Roaring Bull Market which took the Dow to 3000 by 1990. The high P/E ratios came back to haunt investors.

Paul used the example of the Tech stocks leading the Bull Market which peaked in early 2000. The next Bull Market started in late 2002 and just like today, some of the best early gains came from the last Bull Market's leaders—Technology. It was a head fake. Energy and emerging markets turned out to be the big winners. Microsoft, Cisco and Intel skipped the last Bull Market for the most part.

More important to us is who could lead the next Bull Market in U.S. stocks. To understand which groups might be the best place to be you have to ask what were the characteristics at the bottom of prior market lows of the leading sector. First, they were out of favor. This is primarily from poor stock price performance, but also usually because of bad news incorporated in their stock prices which they have no control over. The sector to buy at the 1982 low was consumer staples. The stocks were depressed and they were about to gain the economic benefit of commodity prices dropping dramatically. Lower input prices expanded profit margins and earnings. Coke, Pepsi, Kraft, General Mills, General Foods and Beatrice Foods were some of the names that lead that 1980's Bull Market.

Second, to be the leading sector of the next Bull Market it helps to be the center of attention of the worst things that happened in the prior Bear Market. Banks and Savings and Loan institutions couldn't have been any more out of favor coming out of our national financial crisis between 1988 and 1992. They were despised for being the heart of the problem which caused the first President Bush to not get re-elected because it was "the economy, stupid". With

Enron and the collapse of energy trading in 2001 and 2002 leading the Bear Market down, it was only natural that energy-related stocks bottomed at such depressed prices that they were a powerhouse for stock buyers from 2002 to 2007.

Third, and most importantly, the Bull Market's leading sector offered its future success at a huge discount to the future success of other sectors and the market itself. We measure this by comparing P/E ratios and dividend payout ratios to the market overall and to the sector compared to the last 30 to 40 years. In other words, to find good long-term sectors to roost in, you try to buy the most future success for the least amount of money. What a novel concept!

Which group or sector fits these characteristics today? We believe the drug stocks are an obvious candidate. They have some of the lowest P/E ratios they've had in 20 years and they pay way above average dividends to the market. Their stocks have been poor performers since 2001 and they have the threat of socialized medicine breathing down their neck. Ironically, we also believe they are a great way to play the economic growth in emerging markets (see our missive "Playing Emerging Markets").

Best Wishes,

William Smead

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