Ruminations of

The Contrary Investor

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A 100% Chance of Pain

Investors have clearly been more concerned recently with return *of* their money, rather than return *on* their money. This mindset has resulted in record low interest rates on everything from US Treasuries to mortgages — just about every debt instrument except credit card balance rates, which is whole different subject. For investors still interested in equities, the focus has shifted dramatically to high quality, dividend-paying stocks in the US and stocks in emerging markets.

Two of the smartest guys in the emerging markets and global debt arenas are Marc Faber and Mark Mobius, and the Contrary Investor listens when they weigh in. Their recent comments are very interesting, and definitely worth study.

Investors should stay clear of 10 and 30-year US government bonds, warns Marc Faber, editor & publisher of The Gloom, Boom & Doom Report, following the Treasury Department's recent report that China's ownership of American debt has fallen to its lowest level in a year.

"I think eventually inflation will accelerate," he said. "Whenever food prices go up, and grains have been very strong recently, with the sum delay, you get inflationary pressures." 10-year Treasury yields fell to 2.570%, the weakest level since March 2009. Meanwhile, the 30-year bond's yield reached 2.719%, the lowest level in 16 months. Faber cited a weakening US dollar as a second reason to decrease holdings our country's debt.

"The US dollar will weaken, that's the policy of the US government to weaken the dollar in order to cushion the downturn in the American economy."

"I'm not so keen on Chinese companies...I'm not a great investor in China," Faber said. However, he recommends investing in companies that do business with China, or currencies that benefit from China's growth.

Faber is bullish on India though, believing investors building a portfolio "must" park some of their money in the south Asian economy.

"If I look at the long-term potential....there is an emerging middle class and capitalism has now been truly endorsed by everybody," he said, adding that India also has some "very well run" companies.

In addition to the Asian titans, Faber says Myanmar, Cambodia and Mongolia offer a lot of potential. "Mongolia has the potential to be the Saudi Arabia of Asia because they only have 2.5 million people. It is a huge land mass and very resource rich. They have in the Gobi desert, copper, gold, coal and much more will be found in future."

The new democracy is attracting investments from international mining firms as a result of its untapped resource reserves and close proximity to China.

Mark Mobius is executive chairman of the Templeton Emerging Markets Group, and he believes current fears of a double-dip recession are good for markets, as this will pressure global central banks to stay liquid.

"They're going to have to print and they're going to have to continue money supply increases, and that's good for the global market because it means there's more money available globally."

The bigger worry on Mobius' mind right now is the rapid rise in IPO activity, as that could eventually put downward pressure on prices. "Unless investors finally say 'look, enough is enough we want better prices'... I think there's going be a downward pressure on prices of new IPOs." Over $90 billion has been raised so far this year through initial public offerings in emerging markets, far exceeding the $89 billion raised in 2009.

While Wall Street stocks have wiped out their gains for the year, Mobius highlighted that markets in Pakistan, Thailand and Russia have risen compared with other markets. "These are perceived to be very, very risky but the valuations are good because we see going forward, a positive trend in these markets. We think the year will end up rather than down."

Mobius said H-shares, or Hong Kong-listed Chinese companies, and red-chip stocks, which are China firms incorporated outside of China, continue to look attractive as their domestic China-listed counterparts face foreign exchange controls and liquidity problems. However, he warned that the tremendous amount of IPOs taking place there could have a "depressing effect".

He also sounded a note of caution about Chinese property prices, saying he expects them to fall more than 10 percent on the mainland, particularly the coastal areas in the main cities along the coast. That's one of the reasons why Chinese banks are raising more money because they see a flood of non-performing loans coming down the pipe.

However, the growth rate in China will continue to stay at a high level, he added, thanks to the government's efforts to keep the growth rate at a higher level. "I still see 8-9 percent growth for China this year."

So we have two very smart guys with thoughts on where to invest, and what to avoid, and their direction is definitely not where investors are flocking. What to do with this information?

An interesting corollary that is somewhat synonymous with contrarian investing is known as the “pain trade.” The pain trade is that position that has the potential to inflict the most pain on the most investors, but ultimately in the end, it is the right trade. The pain trade is the most difficult trade, and the trade that yields the best results. It would appear that to engage in a pain trade means taking a contrarian position to the crowd, but not so fast.

For about 20 years, the Contrary Investor has listened to some very talented money managers tout a range of strategies that while contrarian, and attempting to be the pain trade, simply haven’t worked out. And some of these strategies are eerily similar to where we find ourselves today in the US and elsewhere.

A prime example involves Japan’s government debt (JGD). In the 1980s, interest rates on Japan’s government debt collapsed, essentially mirroring where the US is today. Pundits were absolutely certain that rates would rise — they couldn’t go lower — and the pain trade was to short, or sell, JGDs (as interest rates rise, the value of the underlying bonds falls). For over 20 years, interest rates in Japan have remained extremely low, reflecting in large measure the lack of economic growth in that economy, and the trade has been a bust. Sound familiar?

There is a big difference between shorting US Treasuries and avoiding them, as Dr. Faber suggests. Betting with the crowd is never the pain (read: contrarian) trade. But investors need to work hard and think independently to go against the grain successfully. Losers don’t necessarily and magically become winners just because the consensus is voting in a particular direction with their dollars.

Opportunities are out there, but as the old adage says, “you pays your money and you takes your chances.” Pay your money and take your chances in a thoughtful, prudent manner!

- Alex Seagle

Cool Stuff

Readers know that we believe contrarian investing involves the identification of themes that most investors either overlook, under-appreciate, or do not understand. In short, the real money is made at the beginning and the end of powerful themes, and this leads to coming to the table early. One of the themes the Contrary Investor has studied for some time is the notion of non-lethal weapons as the way forward, as conflicts have become increasingly focused on highly populated, urban areas where traditional military force is less effective.

We have weighed in on long range acoustic devices (LRADs) that send incredibly loud, directional noises to disperse enemy combatants, most notably produced by American Technology Corporation (NASDAQ: ATCO), as well as some other very esoteric weapons. Unfortunately, none of the participants in this space have reached profitability, and the companies remain highly speculative. But it's still very cool to study.

The Indian military has a new weapon against terrorism: the world's hottest chili.

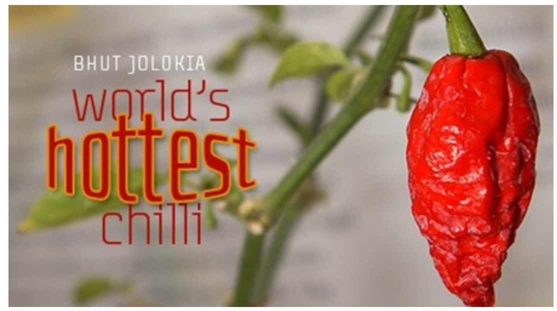
After conducting tests, the military has decided to use the thumb-sized "bhut jolokia," or "ghost chili," to make tear gas-like hand grenades to immobilize suspects, Indian defense officials said. The bhut jolokia was accepted by the Guiness Book of World Records in 2007 as the world's spiciest chili. It is grown and eaten in India's north-east for its taste, as a cure for stomach troubles and a way to fight the withering summer heat.

It has more than 1,000,000 Scoville units, the scientific measurement of a chili's spiciness. Classic Tabasco sauce ranges from 2,500 to 5,000 Scoville units, while jalapeno peppers measure anywhere from 2,500 to 8,000.

"The chili grenade has been found fit for use after trials in Indian defense laboratories, a fact confirmed by scientists at the Defense Research and Development Organization," Col. R. Kalia, a defense spokesman in the northeastern state of Assam, told the Associated Press.

"This is definitely going to be an effective nontoxic weapon because its pungent smell can choke terrorists and force them out of their hide-outs," R. B. Srivastava, the director of the Life Sciences Department at the New Dehli headquarters of the DRDO said.

Srivastava, who led a defense research laboratory in Assam, said trials are also on to produce bhut jolokia-based aerosol sprays to be used by women against attackers and for the police to control and disperse mobs.



The US military spends some $400 billion a year on "stuff" (including, but not limited to $400 toilet seats and $200 hammers). Battleships are no longer in commission; in March of this year the $2.3 billion submarine USS New Mexico was commissioned, but that is the exception, not the rule for military spending. We are simply not directing dollars to the traditional resources, largely because of the way wars are being fought these days. Non-lethal weapons are surely coming to the forefront, and this a long-term trend with a lot of money to be spent on the winners. Perhaps not right now, but soon...this could get hot!

- Alex Seagle

A Pet Project

In our very uncertain investing environment, people are increasingly looking for opportunities that are "recession-proof", at least to the extent that is possible. One way to approach this goal is to look for companies whose products and services have relatively inelastic demand characteristics — that is, they offer things that are the last cuts consumers will make in their spending.

Among the obvious choices are utility companies, including electric, gas and water providers. One can reduce spending on the power bill, but only to a point. As the Contrary Investor continues to study the impact of an aging population in virtually every developed nation, and an interesting option came to the forefront: spending on pets.

According to the American Pet Products Association's (APPA) 2009/2010 National Pet Owners Survey, owners are embracing their pets as true members of the American family. This could be a contributing factor to why spending in the pet market, despite the recession, saw an increase from $43.2 billion in 2008 to $45.5 billion in 2009. Spending in 2010 is expected to reach $47.7 billion.

In the same survey, the APPA points out trends to look for in 2010: big name companies offering lines of pet products; an increase in pet product retailers; upscale and couture pet accessories; pet grooming and pet friendly hotels among others. While most will be spending an estimated $18.28 billion on pet food, pet supply purchases come in second at $11.01 billion.

And this is a global phenomenon. In Australia, for example (where there are more pets than people), spending on pets reached $6.02 billion in 2009, up from $4.62 billion in 2005.

The items pet owners are pumping money into range from the ridiculous to the sublime. A couple of years ago, The Contrary Investor discovered a patented product called “Neuticles.” Neuticles are prosthetic testicular implants for neutered dogs and other domestic animals. Creator Gregg Miller won the 2005 Ig Nobel Prize in Medicine, a parody of the real Nobel Prize, for his invention. Miller developed this truly bizarre offering after his dog wandered off in search of female companionship. He noticed that after Buck (his dog) was neutered to address his roaming, he acted very depressed for quite some time. Apparently, Buck is not alone — as of 2007, more than 240,000 pairs of the product had been sold, in all 50 U.S. states and 49 countries.

But companies making and selling much more main-stream products are attractive as well (is that a pun?). The pet market is the second fastest growing retail industry, behind only consumer electronics, with growth rates varying by component from 4 to 8 percent per year. Pet owners spend more on their pets than on video games, movies, and recorded music. A look at the statistics offers insight into why this is so:

- There are approximately 77.5 million owned dogs in the United States
- Thirty-nine percent of US households own at least one dog
- Most owners (67 percent) own one dog
- Twenty-four percent of owners own two dogs
- There are approximately 93.6 million owned cats in the US
- Thirty-three percent of US households (or 38.2 million) own at least one cat
- Fifty-six percent of owners own more than one cat
- On average, owners have two cats (2.45)

And this doesn’t take into account reptiles, birds, and fish, among other more exotic pets. In fact, about 2/3rds of all households in the US include at least one pet.

Perhaps the most obvious investment to participate in this trend is PetSmart, Inc. (NASDAQ: PETM).

The company reported its second-quarter net income rose 24 percent, and issued a full-year outlook ahead of expectations. The better-than-expected results and 6 percent higher revenue showed PetSmart's results are improving. The Phoenix-based chain operates more than 1,100 stores in North America.

Consumers have cut back on spending as the economy remains uncertain. The results were reassuring that some retailers, at least, are seeing a modest recovery in spending and net income. "This is a great example of success that companies can have when they cut back on capital expenditures, focus on core operations, and allocate capital in a thoughtful manner," said David Strasser, a Janney Capital Markets analyst. "This is a story of a company that is maturing gracefully."

PETM is a play on both the food and pet supply components of spending on pets.

As owners give so much to their four legged companions, the favors are not going unreturned. The APPA lists studies on the health benefits of pets. People who own pets have lower health care costs and fewer doctor visits, pets can help fight depression, prevent heart disease and can lower your blood pressure.

The Contrary Investor has 4 dogs (none of which he bought, but rather was fortunate to find them through rescue efforts and adoption), and has been involved with local Humane Society efforts, recently serving as Treasurer. We like companies that seek to "do good as they do well."

Since 1994, PetSmart Charities, Inc., an independent 501(c)(3) non-profit animal welfare organization, and the largest funder of animal welfare efforts in North America, has provided more than $109 million in grants and programs benefiting animal welfare organizations. Through its in-store pet adoption partnership with Pet Smart Charities, PetSmart has helped save the lives of more than 4 million pets.

The demographic of an aging population is experiencing fewer kids at home, and they are able to spend on their "new family." It appears that one of the last things these Boomers are willing to cut back on is spending on their pets. For investors looking for companies supplying products and services with inelastic demand, pets would seem to be a good bet.

- ❑ Alex Seagle

A Milestone Approacheth

It seems difficult to believe, but in a few short months, *Ruminations of the Contrary Investor* will begin its 50th year of continuous monthly publication! It has been our honor and pleasure to share our humble missive with readers literally around the globe.

We have offered our thoughts on sobering issues and challenges, as well as tried to bring a level of humor to our ramblings. From time to time, we receive thoughtful (and very valuable) commentary from our readers, and we would hope to encourage this process.

Please know that we value your participation in the identification and discussion of themes that will shape the investing landscape. The Contrary Investor will respond to all inquiries and comments. Direct your communication to alex@fraser.com — good, bad or indifferent, and many thanks for your support! Our best wishes for much success in your investments.

- ❑ Alex Seagle

Words to Consider

The smallest bookstore still contains more ideas of worth than have been presented in the entire history of television.

~Andrew Ross

I can't prove it, but I can say it.

~ Stephen Colbert

Let me issue and control a nation's money and I care not who writes the laws.

~ Mayer Amschel Rothschild

The less you know, the more you believe.

~ Bono

Computers are useless. They can only give you answers.

~ Pablo Picasso

Pressure is playing a $5 Nassau with $2 in your pocket.

~ Lee Trevino

Baseball isn't a matter of life and death. It's much more important than that.

~ Anonymous

To be interested in the changing seasons is a happier state of mind than to be hopelessly in love with spring.

~George Santayana

So often time it happens, we all live our life in chains, and we never even know we have the key.

~The Eagles, "Already Gone"

A person will sometimes devote all his life to the development of one part of his body - the wishbone.

~Robert Frost

After all, what is your host's purpose in having a party? Surely not for you to enjoy yourself; if that were their sole purpose, they'd have simply sent champagne and women over to your place by taxi.

~P.J. O'Rourke

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