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Investors Have Cause for Optimism:
Look beyond today's depressing headlines and load up on stocks of large, growing companies.

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With a drumbeat of bad news about the wars in Iraq and Afghanistan, terrorism in England, surging gasoline prices and falling home prices, you can be forgiven for thinking that the world is going to hell in a hand basket. But when you look beneath the surface, there's plenty for investors to cheer about during this Independence Day holiday -- and beyond.

The global economy looks healthier than it ever has, and that is something that many investors have yet to recognize, says Ranji Nagaswami, chief investment officer at AllianceBernstein Investments. At the same time, many parts of the bond market are extremely risky. "Bond investors are acting as if nothing can go wrong," Nagaswami said in late June at Morningstar's annual investment conference, in Chicago.

Let's start with the economy. The volatility of the U.S. economy -- that is, how much it ebbs and flows from year to year -- has dropped dramatically in the past decade. Inflation, growth in gross domestic product (GDP) and growth in corporate earnings are all a lot steadier than they were prior to the mid 1980s. That means fewer booms and busts -- and milder recessions. "We are in an era of tremendous stability," says Nagaswami.

This new stability isn't limited to the U.S. Economies of other developed nations have also become less volatile. Meanwhile, emerging markets have become financially stronger, with their GDPs rising and their debt falling. GDP is growing at 6.5% annually in emerging nations, compared with 2% to 2.5% in developed countries.

The world has changed so much, Nagaswami says, that picking the right industries and stocks is far more important to your investment success than picking the right countries.

Her warning: The low-quality parts of the bond market are priced for a perfect economic environment. But the environment, as the growth in defaults among holders of subprime mortgages underscores, is far from perfect. Junk bonds yield just 2.4 percentage points more than super-safe Treasury bonds. Emerging-markets bonds yield just 1.6 points more than Treasuries. That's an absurd amount of risk to take for little additional return.

The yield gap between lower-grade and higher-grade bonds should widen substantially, and a lot of investors, especially those in highly leveraged hedge funds, will get hurt badly. The good news, Nagaswami says, is that investments in risky credits are limited mostly to institutional investors, limiting the potential damage to rank and file Americans.

The stock market? Mergers and acquisitions around the world last year totaled nearly $4 trillion -- a record. Private equity funds globally raised $300 billion, also a record. And stock buybacks totaled more than $600 billion -- yes, another record. All these activities serve to reduce the amount of publicly available stock. As supply falls, prices should rise. And the boom in buyouts and buybacks "has much, much more room to run," says Nagaswami.

Stocks overall are reasonably valued, but shares of "growth" companies -- those with rapidly rising earnings and revenues -- have become ridiculously cheap compared with shares of "value" companies, which typically sell at fire-sale prices. Whether you look at price-to-sales ratios, price-to-book ratios, price-to-cash flow ratios or price-earnings ratios, "growth has never been this inexpensive relative to value," Nagaswami says.

I've been saying for many months that large-cap stocks and growth stocks look cheap while small-cap stocks and value stocks look expensive. The market is finally beginning to correct that disparity. Over the past 12 months, the large-cap-dominated S&P 500 is ahead of the small-cap Russell 2000 by four percentage points. And through the first half of this year, the Morningstar U.S. Growth index is ahead of the Morningstar U.S. Value index by three percentage points.

What to buy? Funds that specialize in growing blue chips. My favorites are Marsico Growth (symbol MGRIX) and Vanguard Primecap Core (VPCCX). Although it is getting a new manager, T. Rowe Price Growth Stock (PRGFX) is a good fund to hold if you already own it. If you like ETFs, iShares Russell 1000 Growth Index Fund (IWF) is a fine pick.

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