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PDV *OBSERVATIONS*

Buying What's Popular When It's Popular: a Formula for Financial Disaster

Ideally, we would all like to see our investments do well every week, month and year. ***Realistically,*** there is no singular investment approach, ***no matter how good***, that will lead to good investment results all the time. Another way to say this is that nobody, no matter how good, will bat 100% when it comes to making investment decisions.

Rather, good investment strategies are designed to succeed ***much*** of the time, but will nevertheless produce disappointing results from time to time (sometimes for stretches as long as 1.5 to 2 years). This is because investment styles, like stocks, go in and out of favor.

There will be tremendous pressure *emotionally* to abandon time-tested satisfactory investment approaches during inevitable periods of under-performance/disappointment in favor of the "style du jour" that happens to be "working" for the moment. Doing so would be hazardous to your financial health. Recognizing in advance the limitation that good investment approaches cannot realistically outperform all the time will help you resist abandoning time-tested sensible investment strategies because of transitory issues.

On the other hand, bad investment approaches, no matter how poor, will not fail all the time. Bad investment strategies will tend to produce poor investment results ***over time***, but may yield satisfactory results over the short term through luck or otherwise. That's why there are avid followers of "professional investors" who, for example, use astrology to pick stocks. They pick just enough "winners" from time to time through luck to keep followers hanging on. Would you rely on that system as a sustainable long-term winning approach?

It is very important to determine whether good short-term investment performance is based on a good investment approach or bad investment strategy (in which case the good results are unlikely to be sustained over the long term.) The investment process to build wealth over time is kind of like a marathon; you want a sustainable pace so you can get to the finish line (though you'll encounter some inevitable bumps and detours along the way), not

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an erratic sprint that makes you look good over short distances but will burn you out before reaching the finish line. That's why we keep reminding clients that short-term results, good or bad, are not particularly meaningful or necessarily indicative of long-term performance.

> *Realistically,* there is no singular investment approach, *no matter how good*, that will lead to good investment results all the time. Another way to say this is that nobody, no matter how good, will bat 100% when it comes to making investment decisions.

Consider the following example of a poor investment strategy that has been widely embraced because of its recent success. Over the past couple of years, *buying what's popular when it's popular* has beaten all other investment strategies hands down. Following the herd and prevailing consensus has been rewarding indeed. This has meant chasing and buying the big multinational blue chip companies *at any price.* Valuation, while of paramount importance in the long run, has been totally ignored as an analytical tool. Big is beautiful. Small companies have been uniformly shunned, despite some attractive prices and business prospects.

Jim Gipson, the legendary manager of the Clipper Fund, shared his sentiment about this recent mindless momentum-based investment mania by stating in a recent shareholder letter: "There are times that successful investing requires brainpower. This is not one of those times."

Consider another legendary money manager, Robert Rodriguez, who manages the FPA Capital Fund (closed to new investors). Bob has one of the best ***risk-adjusted*** long-term investment records extant. Here at ***PDV***, we've been long-time admirers of Bob's investment acumen and approach. About a year ago, we were fortunate enough to have spent two hours over lunch talking with Bob and came away as impressed as ever with his investment philosophy and insights.

You see, Bob is an old-fashioned investor who likes to *buy low, sell high.* This may seem downright stodgy to some amidst the recent momentum-based market environment. He believes valuations are of paramount importance and doesn't want to buy high and then try to find a bigger fool to buy the stock at an even higher price. Bob, therefore, has clearly been out-of-step with the "greater fool theory" of investing that has been pervasive in the past couple of years. Moreover, by charter, Bob is required to buy only small and mid-cap companies, two groups that have been in the doghouse the past several years. He's a value-oriented contrarian investor who's about as different from the "buy what's popular when it's popular" momentum herd as you can get.

Despite having one of the most remarkable risk-adjusted long-term investment records extant, his investment style and the type of stocks he likes have been decidedly out of favor in the past two years. Consequently, Bob's performance over that time period has been less than stellar. Bob Rodriguez is a prime example of someone with a good investment approach who will in all likelihood shine again as he has done over the past 15 years. However, even he can't avoid some bumps along the way.

> The investment process to build wealth over time is kind of like a marathon; you want a sustainable pace so you can get to the finish line (though you'll encounter some inevitable bumps and detours along the way), not an erratic sprint that makes you look good over short distances but will burn you out before reaching the finish line.

On the other hand, the novice investor who bought the hot internet stock of the week with no earnings has been beating the pants off Bob, at least for now. Is the novice just lucky in the short run by buying what's popular when it's popular, an investment approach that happens to have worked recently, but which historically has been empirically proven to be a lousy strategy? Can we have any confidence that the novice investor can continue to outperform over time based on this strategy?

The moral of the story is to be careful about abandoning well thought-out time-tested investment approaches that have proven to be successful over time just because recently they have not been "working." Patience is a rare but essential quality for investment success. While the wait for recovery to respectability may at

times seem like an eternity, good investment approaches will shine again over time.

As a corollary, be wary of adopting unprincipled investment approaches that are "working out" for the moment, since they are likely to produce unsustainable and poor results over the long run. While poor approaches will not fail all the time, they will fail most of the time. Buying what's popular when it's popular is a formula for financial disaster, notwithstanding the success it has enjoyed over the past two years.

Review of Earlier Observations

From time to time, we will write follow-up articles on observations we made earlier. The intent behind some of these reviews is to illustrate how Wall Street consensus can often be misplaced.

Let's first look at the performance of stocks over the past few months. While small and mid-sized companies collectively saw their stock prices peak in April 1998, big-cap stocks were still performing relatively strongly three months ago. Prevailing Wall Street consensus at the time embraced the apparent "safety" of large liquid blue-chip companies and their assumed ability to continue growing their earnings at both a high and sustainable rate. Just as this consensus became most widely embraced, the big-cap stocks collectively peaked out in July 1998, illustrating once again the market's tendency to fake out the maximum number of people.

Here at ***PDV***, we took a contrary view. In the Summer 1998 issue of ***Observations***, we discussed two developments that suggested an imminent slow-down in the U.S. economy and corporate earnings. These included the partly inverted shape of the Treasury yield curve and the overly bullish tone in the "junk bond" market.

> The August 28, 1998 edition of the Wall Street Journal ("WSJ") indicated that only 14 stocks on the New York Stock Exchange hit 52-week highs that day, while 991 hit 52-week lows. The high-low ratio on the NASDAQ was an even more astounding 4:1000!

On the issue of the shape of the Treasury yield curve and its relationship to possibly slowing economic growth, we wrote the following in the Summer 1998 issue of ***Observations***:

"What might the shape of the Treasury yield curve be telling us about future economic conditions? …The bond market appears to be expecting markedly slower domestic economic growth in 1998…A domestic economic slow-down could be devastating for U.S. corporate earnings, leaving the grossly overvalued U.S. stock market vulnerable to a steep correction."

On the issue of the then manic buying of junk bonds three months ago and its implications on slower economic growth, we wrote:

"If you want another sign that an economic slow-down may not be that far off, look at what has been happening in the junk bond market…we believe that investors are too complacent about the risk of default associated with junk bonds, and are being inadequately compensated by yields that are only marginally higher than those offered by investment grade bonds. Often, asset classes become most popular shortly before they implode…investors may be clamoring for junk bonds at just the wrong time, just as exuberant investors chasing overvalued stocks may be too sanguine in their view that good economic times will continue indefinitely."

Since we wrote these passages three months ago, U.S. economic and corporate earnings growth have drastically decelerated. Many U.S.-based multinational companies, facing reduced global demand and rising global turmoil, have begun announcing disappointing earnings.

In reaction to these developments, the stock market has been pummeled. Here's a flavor of the damage. The August 28, 1998 edition of the Wall Street Journal ("WSJ")

indicated that only 14 stocks on the New York Stock Exchange hit 52-week highs that day, while 991 hit 52-week lows. The high-low ratio on the NASDAQ was an even more astounding 4:1000! The average stock incredibly has fallen more than it did during the 1987 market crash (WSJ August 18, 1998). While a handful of big glamour stocks and their disproportionately huge weighting have so far limited the damage to big-cap capitalization-weighted indexes such as the Dow Jones Industrial Average and the S & P 500, the Russell 2000 (a small-cap index) from peak to trough fell just shy of the 34.5% slide in 1987, which was the worst year on record for that index (Barron's August 31, 1998). And yet three months ago before all this unfolded, Wall Street consensus was still expecting a reacceleration of corporate earnings growth in the second half of 1998, thereby propelling the market to new highs.

The carnage among junk bonds has been no less drastic or painful. August 1998 was the worst month for junk bond performance in the past 8 years (WSJ September 8, 1998). Some of the same over-leveraged closed-end junk bond funds that we panned in the Summer 1998 issue of ***Observations*** collapsed (Barron's August 31, 1998).

We noted in that issue: "…***closed-end*** high-yield bond mutual funds are finding favor with investors again. *They haven't been this popular since the late 1980's,* ***just before*** *the junk bond market imploded. Closed-end mutual funds generate huge commissions for the brokerage companies that bring them to market*. They are typically brought to market when demand for them are strong (often after the asset class in question has already been on a tear for several years and may have begun running out of gas) and exuberant investors are willing to overpay for them."

Haven't we seen this movie of greed and fear before? Did the Wall Street sales machine once again sell financial products to the public that were inappropriate, but nevertheless generated huge commissions? Did some investors, perhaps blinded by greed and overwhelming consensus thinking, share part of the responsibility for buying at the top?

The foregoing, in our view, is just another example of the riskiness of investing according to prevailing consensus. This method is risky because a consensus is usually formed ***after*** trends have already been established and most people have already acted.

As economic growth slowed, investors began fleeing junk bonds in droves (even as prices fell and became more attractive), though they were embracing many of the same junk bonds at higher (and therefore less attractive) prices as recently as three months ago. ***Investments and perfume may be the only two things that people find more attractive at higher prices!***

While one might argue that investors' change of heart is justified by changed circumstances, the fact is that the factors pointing to slowing economic growth (which was bad for junk bonds) were apparent three months ago to anyone who could resist "group-think" and took his/her rose-colored glasses off to do some independent thinking.

The foregoing, in our view, is just another example of the riskiness of investing according to prevailing consensus. This method is risky because a consensus is usually formed ***after*** trends have already been established and most people have already acted. In fact, it's often their collective actions that establish the consensus. Consensus-based investing is really a form of "rear-view mirror" investing, and will generally be hazardous to your ***long-term*** financial health because markets are a forward-looking discounting mechanism.

Real Estate Investment Trusts Revisited

After two consecutive years of spectacular performance, real estate investment trusts (a.k.a. "REITs") have turned in a miserable performance so far this year. Despite a fairly strong rebound recently, REITs nevertheless have posted disappointing results in 1998. For a discussion of the basics on REITs, please see the Winter 1996 issue of ***Observations.***

Investors' overreaction has been swift and predictable: sell first, ask questions later. What happened to all the talk about how the contemporary investor is more sophisticated, well-informed, patient and long-term oriented? Here at ***PDV Financial***, we sometimes joke that Wall Street's definition of a long-term investor is one who doesn't bolt as long as the investment is going up. In fact, REIT investors' lack of patience doesn't surprise us (as to why, please see "The Dichotomy Between the Intellect and the Gut" in the Winter 1997 issue of ***Observations***).

There have been many reasons cited for the poor performance of REITs this year. First, spectacular performance in 1996-97 resulted in escalated REIT share prices at the start of 1998. This in turn triggered a lot of initial public offerings and caused existing REITs to issue additional shares. The drastically increased supply swamped existing demand, putting downward pressure on REIT share prices as the year progressed.

Second, there was anecdotal evidence that the ample liquidity available to REITs caused them to pay ever-higher prices for properties, thus lowering the initial yields on their acquisitions.

Third, there was a sense that the real estate recovery was well established, and the cycle was peaking. Growing rents were beginning to spur new construction in select markets for certain property types (traditionally a sign signaling that the peak in the cycle is approaching).

Fourth, Congress had proposed legislation that would have adversely impacted some REITs. While the legislation was limited in scope, it nevertheless resulted in indiscriminate selling of REITs across the board.

While many of the foregoing concerns had some legitimacy, they were nevertheless overblown. As is often the case, the truth was somewhere between the bullish and bearish case.

First, new construction, while surfacing again, is only appearing in select markets and for certain property types. It is nowhere near the alarming levels that we saw during the period preceding the most recent real estate recession.

Second, the scope of the legislation originally considered by Congress has been substantially pared back, and ended up materially affecting only a very limited number of REITs.

Third, as REITs have increasingly turned to the public markets for financing in the past few years, the capital markets have in fact imposed badly needed fiscal discipline on REITs, a factor that was largely absent in the late 1980s. While the drop in REIT share prices and the reluctance of lenders to continue lending ferociously to REITs have caused some short-term pain by limiting access to the capital needed to facilitate more acquisitions and external growth, it has had the long-term ***salutary*** effect of preventing REITs from continuing to engage in bidding wars at absurdly high prices. The capital markets have sent their message loud and clear: growth is only good if it can be achieved

profitably. REITs thus have been forced to behave more prudently by resisting profitless growth.

Fourth, with low interest rates, moderately strong domestic economic growth, and improved supply/demand equilibrium, the real estate cycle, while quite mature, should not be heading into a recession imminently.

Investors' collective overreaction to the over-stated bearish case for REITs has driven REIT valuation from one of moderate overvaluation at the beginning of 1998 (after two splendid years in 1996-97) to the present one of drastic undervaluation.

In fact, arguably REITs as a group has not been this undervalued since the early 1990's when the real estate industry and the economy were in recession. REITs, despite their added liquidity compared to direct ownership of real estate, now generally sell at a sizable discount to the value of the underlying real estate they hold. Their average yield is over 4 times the yield of the stock market, and the yield they offer is at historically attractive levels compared to the 10-year Treasury note. In sum, for the next couple of years REITs are projected to grow their cash flow faster than non real-estate stocks and offer higher dividend yields, and yet currently sell at much lower valuations.

While we would *not* suggest a full weighting of REITs for your portfolio at this point of the real estate cycle, it may well be the right time to take advantage of all the doom and gloom and investor overreaction surrounding the REIT industry by including at least a REIT component in your portfolio.

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