FALL 1999 VOLUME 5:3

PDV *OBSERVATIONS*

A Brief Market Update

Rising interest rates and Year 2000 concerns pounded most stocks down indiscriminately in the past quarter, abruptly stopping the incipient resurgence of value stocks. Even the widely loved Internet and big-cap growth stocks did not escape unscathed.

The cumulative advance-decline line that measures the number of stocks advancing versus declining on a cumulative basis has been hitting new lows day after day. Incredibly it is now lower than the nadir reached last October when the world seemed to be falling apart because of the global economic crisis.

Lots of stocks are not only down substantially for the quarter, but for the year as well. During a recent trading day on the New York Stock Exchange, 32 stocks hit 52-week highs while 298 stocks hit 52-week lows. The Dow has dropped over 1000 points since late August.

We don't know what the market will do tomorrow, much less three months from now. However, the stealth bear market has generated a lot of reasonably priced stocks (outside the Internet and "Nifty-Fifty" sectors). For example, the equal-weighted Value Line Index is selling for only around a 15 p/e ratio, which is very reasonable given present levels of inflation. Since stock prices and business values converge over time, anyone owning a portfolio of undervalued securities should look forward to good appreciation over the long term, even though there may be some short-term pain associated with the current indiscriminate decline of most stocks.

The Art of Selling

Much has been written and said about how and when to buy stocks, while very little is available to guide the sale decision. We have heard many investors lament how difficult it is to know when to sell a stock.

There are numerous guidelines that can be used to decide when to sell a stock.

1. <u>Try to Sell At or Near the Top</u>. This is an ideal solution, and one that everyone has tried to attain at one time or another during their investment experience. Unfortunately, it can't be done on a consistent basis. Yes, the element of luck can help you achieve this once in a while, but not with any predictable success. You'll need to adjust your expectations about the feasibility of this solution, or you'll be constantly frustrated.

Have you experienced locking in a huge return on a stock, only to see the stock double or triple after your sale? If so, don't feel too bad because you're among some fine company, including legendary investors Sir John

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Templeton and Warren Buffett. They readily accept the fact that selling near or at the top consistently is an unrealistic and unattainable goal, and you should too.

2. Sell After a Predetermined Amount of Appreciation. Some people like to sell if and when the stock appreciates by a predetermined percentage. Investors who use this sale method are usually heavily influenced by the Wall Street adage, "Nobody ever went broke taking profits."

In our view, such mechanical formulas are not particularly helpful. A stock does not know how much paper profit you've made. While on a short-term basis, any stock experiencing very recent strong appreciation would likely "pull back" from time to time because of profit-taking, ultimately business fundamentals and the level of interest rates determine appropriate long-term stock prices.

If a stock was previously very undervalued and/or the intrinsic value of the underlying business is growing over time, there is no reason why a stock enjoying great appreciation cannot continue to increase over time. Selling after an arbitrary and predetermined percentage of appreciation has been reached can take away further appreciation potential from an undervalued stock whose price still lags the underlying business fundamentals.

3. Sell After a Predetermined Amount of Depreciation. Investors employing this approach sell any loser once it drops below a certain price. This approach has at least one salutary aspect. Any successful investment strategy ought to be designed to limit the damage inflicted by some inevitable losers in the portfolio. A sale discipline intended to cut losses early certainly advances this goal.

One weakness of this approach, however, greatly limits its benefits. Since short-term movements in stock prices can be quite random, and are more affected by mass psychology than fundamentals, you could likely end up selling a stock that has dropped in price due to temporary and perhaps non-fundamental factors. By the time you realize this and try to buy back in, the price may have already increased beyond your reach.

This weakness can be partially addressed by widening your predetermined limits before your sale is triggered. However, if you set these limits too wide, then it defeats the beneficial effects of limiting potential losses early.

4. Wait to Sell a Loser Only After It Breaks Even. Someone following this method might have the following thought process: "I'd rather have a root canal than admit I made a mistake getting into this investment, so I'll only sell when I at least break even. I'm patient, so I'll wait 10 years if necessary." To make matters worse, if someone bought the stock for a quick profit, what started as a short-term speculative trade becomes an "involuntary" long-term hold for ego reasons.

This type of thinking is prevalent and unsurprising. Psychological studies have shown that for most people, the pain associated with losing money is greater than the joy they experience from making money. Emotionally, investors find it very difficult to lock in losses.

The decision whether to keep holding is made more difficult by the fact that the turnaround for some losers is well worth waiting for while others may never materialize. Losers all look the same while they are down. You need both knowledge and expertise to distinguish between losers whose lower prices are justified by the likely diminished long-term business prospects, from those with genuine turnaround potential. Stubbornly waiting for a turnaround that has bad odds of materializing unnecessarily ties up capital that can be better utilized for other investments.

5. PDV Financial's Sale Guidelines. Here at PDV, we sell under one of three circumstances: a) the stock has become grossly overvalued, b) after taking tax and transaction cost considerations into account, a much more compelling investment comes along, or c) subsequent events following our stock purchase have demonstrated an unexpected and likely permanent deterioration in business value that is not adequately discounted by the stock price.

"Grossly overvalued" means that the stock price has exceeded the top end of a range of reasonable business values for the underlying company and incorporates some unrealistic assumptions about its profitability, growth rates and other financial and operating factors that appear very difficult to achieve.

Most of our sales are of grossly overvalued securities that have appreciated. These stocks are almost always experiencing positive price momentum at the time of our sale, as the formerly out-of-favor stocks are being once again embraced by the investment masses. Short of luck helping us catch the top, these stocks will probably continue to climb after we sell because of the positive sentiment surrounding them. Therefore, there's almost always a *short-term* opportunity cost to selling because our clients would probably continue to benefit from a rising price had we not sold (at least for awhile).

We are willing to incur this short-term opportunity cost ***because doing so actually yields greater benefits for our clients over the long term.*** We would not sell any stock unless it was grossly overvalued. By definition, an overvalued stock has limited long-term appreciation potential (since value and price converge over time), even if investor herd mentality might continue to push the stock price up in the short run. On the other hand, any sale proceeds will only be redeployed into undervalued securities (which by definition implies greater long-term appreciation potential).

Our sale discipline, therefore, can make us *look* bad in the short run, because we are exchanging stocks with positive price momentum with those usually experiencing negative price momentum (that's why we can buy those cheaply, because they are out-of-favor and undervalued.) But in reality, we are rebuilding the foundation that will likely sustain better long-term returns than if we had stayed with the overvalued stocks, because we've increased the long-term appreciation potential embedded in client portfolios. ***We are willing to look foolish in the short run if we are in fact doing something intelligent in the long run to benefit our clients and their portfolios***.

The Crucial Link:
Realistic Expectations & Good Investment Results

There are many factors that tend to promote good sustainable long-term investment results. One of the more important involves having realistic expectations about what a well-thought out investment strategy can do for you as well as its limitations. This will help you stick with winning strategies during inevitable periods of underperformance from time to time.

You've heard it from us before. No investment strategy, no matter how good, works all the time. On the other hand, no investment strategy, no matter how bad, will fail all the time. Even successful investment strategies will generate alternating periods of outperformance and underperformance (including possible losses). A good investment strategy *over time* should produce 6 or 7 winners out of every 10 investment selections, and minimize the damage from the 3 or 4 losers, thereby generating satisfactory long-term returns. For example, the legendary Peter Lynch admitted his batting average was around 6 out of 10.

Having unrealistic expectations regarding what a well-thought out investment strategy might achieve for you will likely hurt your long-term results. For example, if you thought a good investment strategy always achieves a 100% batting average (yes, lots of people think this way), then you are likely to abandon a good strategy going through the occasional and inevitable lagging period. Let's look at an example of how having the right expectations can help you stay on track towards long-term wealth creation. We will analyze the stellar Sequoia Fund through the eyes of two different hypothetical investors who are currently invested in Sequoia. Investor "A" has realistic expectations about the limitations of a good investment strategy, while investor "B" does not.

First, let me give you a little background about the Sequoia Fund. It is managed by Bill Ruane and Bob Goldfarb, who have achieved stunning risk-adjusted returns over the past 30 years. Sequoia's record is in fact one of the best around. Few have been as good for as long. If you're interested in winning a marathon rather than a sprint, these are the guys you want on your side. (Sorry, the fund has been closed to new investors for years.) This year, however, has so far been very unkind to the Sequoia Fund. Because of its heavy concentration in financial stocks that have been indiscriminately hit by rising interest rates, the fund is down about 18% year to date.

A knows Sequoia's investment strategy supports sustainable long-term results. Metaphorically speaking, since A is interested in winning a marathon and not a sprint, A will likely maintain or even add to his position in the Sequoia Fund. He knows the fund's lagging performance is to be expected once in a while and certainly not out of line with the current malaise that other value-oriented managers are experiencing.

On the other hand, B is likely to conclude Bill Ruane and Bob Goldfarb have somehow "lost their touch." B will likely believe, unrealistically, that good investment strategies win all the time. If the fund is down that much this year, it must be pursuing a flawed strategy.

So being impatient and unrealistic, B decides to switch to a "hot" fund that chases overvalued big-cap growth and Internet stocks. Because B erroneously thinks bad strategies fail all the time and this "hot" fund is working, by definition it must use a good investment strategy. He is therefore likely to abandon the "train" that will go the distance for another that will sprint for awhile and then break down, perhaps permanently.

I can assure you this type of thinking is pervasive. People naturally want to "win" all the time. Paradoxically, by jumping from style to style in search of what's working, they greatly harm their odds of successfully accumulating wealth over the long term.

It has been widely reported that many shareholders of the Fidelity Magellan Fund under Peter Lynch's tenure actually failed to make any money because they abandoned the fund during periods of lagging performance (i.e. sell low) and chased the fund after periods of outperformance (i.e. buy high). Yes, even Peter Lynch's spectacular career contained some forgettable periods of lagging performance.

When judging the efficacy of an investment strategy, you need to be aware that even the best strategy will involve a certain amount of short-term emotional pain from time to time because of inevitable periods of lagging performance. Knowing this in advance and being psychologically prepared for it will help you stick with winning investment strategies even if they don't and can't "win" all the time.