Fall 2002

VOLUME 8:3

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

PDV Developments

We would like to share some exciting news about ***PDV Financial Management.*** 2002 has proven so far to be our best year for new business, since PDV's founding over 8 years ago. We are most gratified by and grateful for the extraordinary business growth we have experienced this year. Many existing clients have either consolidated accounts previously managed elsewhere with PDV, or added additional assets to take advantage of the current depressed stock prices. We have also established investment advisory arrangements with a record number of new clients through referrals this year. We greatly appreciate and thank you for your support!

As we mentioned before, PDV does not strive to be all things to all people. We have turned away significant business this year from potential clients who would not be a good fit for PDV. We do not want to be distracted from delivering the high level of service that our clients deserve from us.

To service the tremendous growth of our business, we're excited to announce that we have 1) recently expanded our office space to accommodate a larger staff, and 2) added two new employees who will be helping with investment research and analysis as well as operational issues. We are contemplating possibly adding a third in the not too distant future.

We also want to let you know that PDV has raised its ***investment account minimum from $250,000 to $500,000,*** effective immediately.

We are always pleased to be of service to those who have the interest and patience to seek long-term wealth accumulation through value investing. If you can think of anyone who might benefit from our investment philosophy and style, we would be most pleased to hear from you. Thank you so much!

Market Reversal?

We think a significant market reversal may be developing; our wild guess is that within six months, the market will likely be meaningfully higher. No, we are not nuts! Yes, we admit it is very unusual for us at PDV to make market predictions, as we have never professed to be one of those all-seeing gurus whose purported expertise is being able to accurately predict the direction of the markets. Rather, ***we believe our strength at PDV is to bring integrity, an unemotional temperament, patience, discipline, analytical rigor, and a thoughtful and deliberate valuation approach to the investment process in assisting our clients reach their financial goals over time.***

With the pervasive doom and gloom, we thought we would make an exception in this case and join the crystal-ball gazing crowd. Judging by the sorry record of all those gurus who throw out market calls every other day, we don't see any harm in tossing out our opinions as well. We want to stress that this is just a wild guess on our part; ***nobody should rely or act on this.*** With that caveat out of the way, we are seeing a lot of signs that in the past have pointed to an inflection point being reached and a market reversal not being too far behind. But before we get into what these signs are, we present a brief summary of the carnage that is Wall Street in the past several months.

This recently concluded quarter was the worst third quarter for the markets since 1987, and this current bear market (already deep into its third year) has become one of the three most severe of all times, surpassing even the crushing bear of 1973-74. We have seen indiscriminate, persistent and heavy selling in the markets for the past 6 months. During this time, there have been no places to hide in the equity markets...period. Undervalued stocks got cheaper, as did overvalued stocks. In most (but not all) market declines, un-

Inside This Issue:

* *PDV Developments p.1*
* *Market Reversal? p.1*

dervalued investments tend to hold up better. This most recent decline is one of the few where undervalued investments fell as hard as overvalued investments. But, the undervalued investments will rebound strongly when the markets begin to stabilize; the same cannot be said for overvalued investments.

Against this seemingly dire back-drop for the market, it is most difficult to find any hope or optimism. So, we will offer some. We are going to get right to the point, and present below a list of signs that in the past have proven to be reliable indicators of positive market reversals.

Regression to the Mean

The investment herd and the media are uniformly bearish at this point, with daily predictions that this market will drop another 30-50% etc. People are clamoring to beat each other in coming up with more and more outlandish bearish predictions. The rampant fear and despair show that we have become too negative, and will in time swing back towards the mean. The nature and extent of this negative sentiment also indicate we are stretched way beyond the mean on the downside, and is getting closer to the inflection point with every additional decline.

Markets go to extremes in either direction because of greed and fear, but have a strong tendency to regress around the mean. Events that are statically aberrational (several standard deviations from the mean, in technical jargon) will revert towards the mean over time. But fear and greed make people think that the further the markets stretch beyond the mean, the further it will keep going in that same direction; in fact the odds overwhelmingly favor an inflection point being reached and the markets changing direction. We tend to be "trapped in the moment and confined to the immediate reality, faced with a myopic view of the road ahead." When confronted with seemingly threatening uncertainty, we are wired psychologically to be unable to "see more than two inches past our noses." We saw this type of behavior in spades in the past 5 years. Just as people extrapolated the continuation of a bubble that was totally aberrational, they are now extrapolating the continuation of a market collapse that is aberrational on the other side.

The fact is that the current bear market already ranks as among the worst three of all times, and the historically significant drop that has already occurred makes it much more likely that the market will go up than down over the next 6 months. Part of the savage drop is justified (as the previous excesses are cleaned out), but the numerous undervalued stocks that we are now seeing leads us to think this is way overdone on the downside at this point.

Panic-Selling of Stocks Reaches Fevered Pitch

When a market trend becomes so entrenched and established that the predominant majority of investors hop on with abandon, it's abut time to consider doing the opposite. Market history has proven this over and over. People are naturally wired to chase asset classes long after they have been performing well. Witness how investing first in stock mutual funds, and then in stocks directly (because investing indirectly through the vehicle of mutual funds was deemed too tame at the height of the bubble) became a national pastime not long ago. Much of the public's money came in long after the market began taking off in 1995. Most of this money came in just in time to see the NASDAQ-type stocks collapse.

Now we have the mirror image occurring. With stock prices much lower across the board, we have the investment herd selling in panic, many swearing off stocks forever. Buy high, sell low. Many professionals do this too, to appease their clients' predisposition and desire to chase "hot" investments with momentum and sell "ones" that are dropping for whatever reasons. Don't think this is true? How many clients encourage their advisors to buy more of an investment when the price is dropping, as opposed to voicing their concern at the price declines?

How bad has the public's distaste for equities become? Figures differ, but the masses reportedly sold over $70 billion from stock mutual funds in 2002 3rd quarter alone. The selling has continued in October. When the investment herd abandons an asset class to such an extreme, all heading in the same direction, one can pretty much count on the fact that asset class is likely to start doing well in the not too distant future. Where is the public putting its money? You guessed it—primarily in the three asset classes that have enjoyed good recent performance (at least relatively speaking). These include 1) bonds, especially treasuries, 2) CD's and money market funds, and 3) real estate (via both direct and indirect ownership).

Again in each of these cases, the masses are flocking to an asset class long after recent relative out-performance. Paradoxically, treasuries are probably one of the riskiest investments right now. Yes, you read that correctly. Before you insist that we get our heads examined, let us explain. Treasuries have no default risk, but the longer term treasuries have interest rate risk. When interest rates move up, the value of a treasury will decline. The longer the term of the treasury you hold, generally the more it will decline for a given increase in interest rates. The flight to safety in the past 12-18 months has generated huge demand for treasuries, pushing their price up greatly. It is overdone. With short term rates at 40-year lows and long-term rates also low on a historical basis, the direction of interest rates over the next 12 months is more likely up than down. If this were to happen, the price of all treasuries, except for very short-term treasury bills, will decline, perhaps substantially.

Retreating to CD's and money market funds are not much better. The current yield of 1-1.5% per year will not get people to their financial destination. Of course, if and when short term rates move up, at least investors in these investments have a chance to re-invest at higher rates. But at 1-1.5%, we are a long way from where yields need to be so people can achieve their long-term financial goals relying on such investments.

Real estate, as an asset class, is very complex to analyze, and no generalizations can be made about its attractiveness at this point. You can invest indirectly by buying shares in publicly traded real estate investment trusts (a.k.a. "REIT's") or real estate operating companies (a.k.a. "REOC's"). Some are still quite attractive, despite recent strong performance, while others face imminent cuts in dividends that look deceivingly good on their face. However, anecdotal evidence indicates that the type of real estate attracting the most dollars right now is good old-fashion residual real estate. In our view, this will end badly, as it did in the early 1990's. Why?

It has to do with the supply/demand situation. Already, home foreclosures recently hit a record high, adding to the supply of housing on the market. This situation is not likely to get better any time soon, as the refinancing boom of the past few years has allowed a lot of people to take "cash out" of their houses, thereby increasing the size of the mortgage they have to service. With the unemployment rate so high, more foreclosures are inevitable. Meanwhile, the price appreciation in residual real estate has vastly outstripped income growth in the past few years. Economically, this divergence cannot be sustained, eventually putting further pressure on housing prices and values.

Through all of this, there is clearly one asset class that the public wants to stay as far away from as possible—stocks. In some cases, this is nothing more than "keeping up with the Joneses" or what psychologists call "social proof." the following scene is probably being played out in living rooms across America. Investor A's neighbor who 1) teased him three years ago about all the tech stocks he was missing out on, and 2) lied to him about all the gains the neighbor was making, is now chiding Investor A for missing out on all the gains the neighbor is supposedly making flipping "must-win" residential real estate. It turns out the neighbor is still lying to Investor A, as he's still sitting on all the tech stocks that he was bragging about, which have now all lost 99% of their value, with little rebound potential. Investor A just can't stand being baited by his neighbor, and decides to sell all his stocks (some of which have good rebound potential) at multi-year lows to "invest" in residential real estate at multi-year highs. You know how the script ends.

Let me use a metaphor to capture the essence of what we mean. To achieve your financial goal, you have to make rational and thoughtful plans to reach your financial destination. No matter how carefully you prepare for your trip, you know the journey will not be entirely smooth, with bumps along the way, poor weather and heavy traffic at times, and other factors that are out of your control. Have you ever been tempted to change lanes on a freeway, just because another lane happens to be moving faster at that time? More often than not, the alternate lane seems to stop just as you turn into it, while your original lane starts moving! Some people get so frustrated that they get off the freeway completely, because they want to "wait" until the traffic disappears...except the traffic never completely disappears, because the markets are always infected with a mixture of uncertainty, and negative as well as positive news. During bull markets, people tend to ignore the negatives (even though they are there), and they tend to do the opposite during bear markets, by focusing only on the negatives. Getting off that freeway (by panicking out of equities partially or completely) will likely mean you will never reach your financial destination. For instance, right now people are very worried about war, as they should be. Going to war is a very serious matter. But is the likely impact on the markets so definitely negative as everyone seems to have already concluded? How many people remember that The Gulf War in fact pulled the market out of the bear grips at the end of 1990, contrary to prevailing expectations at the time?

Follow the Mutual Fund Flow: Janus Part II

During the height of the bubble 3 years ago, there was no hotter mutual fund family than Janus. They walked on water—and arrogantly reminded people of this fact every chance they got, in the media and in print. They owned all the hot stocks that were working, with all the momentum. They claim to be valuation-sensitive, but in hindsight we found out nothing could be further from the truth. Out of every dollar of money going into stock mutual funds, something like close to 70 cents went into Janus stock mutual funds at the height of the bubble. This is simply astonishing, as there are probably at least 5000 other different stock mutual funds out there to choose from. The media was fawning all over them. The Janus investment professionals began to believe their own press, shoveling all the new money rushing through their doors into the very same overvalued stocks that were already in their mutual funds. For a while, this created a self-fulfilling circle of strongly performing stocks in Janus mutual funds getting stronger, which of course attracted more of the public's money. Janus then used this flood of new money to buy more of the same stocks and so on and so forth. In contrast, nobody wanted to invest in bond funds, even though bond prices were attractive. Janus eventually grew many-fold to become one of the largest five mutual fund companies, until it started imploding along with the NASDAQ in March 2000. it is now a skeleton if its former self.

Fast forward three short years, and people are pulling their money out of Janus in droves, like somebody just yelled fire in a crowded theatre. The results produced by Janus since March 2000 read like a Stephen King horror novel. Janus is still bleeding assets as we write this. In contrast, over $100 billion have reportedly flowed into bond funds of various stripes so far in 2002, and the flood continues. The PIMCO Total Return fund, a stellar bond fund run by Bill Gross down in Newport Beach, California, is garnering the lion's share of the money going into bond funds, somewhat reminiscent of the Janus phenomenon at the height of the bubble. In fact, just last week Bill's fund became the largest mutual fund in the industry, whether of the stock or bond variety. Now let us be very clear about one thing—Bill is undeniably on of the best bond fund managers in the world, and many PDV clients in fact own positions in his fund, much of it bought over the years when bond prices were much lower. Bill's skills, which are undeniably stellar, are not the problem. The issue lies in the fact that Bill, normally mild-mannered and humble for someone so accomplished, has decided to go beyond the subject of his expertise, and start commenting on the stock market. He is very bearish of curse. Could he be getting a little too full of himself for his own sake? His fund is likely to continue to do well in the bond world; I have much less confidence in his recent stock market predictions however. How difficult and how much courage and conviction does it take for someone to dump on the market after the S&P 500 and the NASDAQ have

already collapsed close to 50% and 80%, respectively, from the top. Contrarians take note.

Demand and Supply of Stocks

Markets tend to move up when the supply/demand balance tips in favor of demand for stocks. While there is little demand from the investment public right now for stocks, there is an important (and knowledgeable) source of demand that is increasing. Many companies, judging that their decimated stock prices do not adequately reflect the value of their company's long-term business prospects, have announced giant stock repurchase programs. While some of these announcements are for cosmetic or public-relations purposes, many companies are putting their cold hard cash to work in implementing these buyback programs. More buyback announcements are being mad as we write this. As these programs accelerate, a significant source of support will be established for the markets. Who better than the management of these companies to judge whether their own stock is undervalued?

In addition to the decision to utilize corporate resources to fund these corporate share buy-back programs, management closest to the companies' prospects are also putting their own money at risk. Normally, insider buying is greatly outweighed by insider selling, because there are many more reasons for insider selling. As stock options or other stock awards can often form a large portion of compensation, management often sell as a routine matter to diversify and produce funds to pay ordinary living expenses. This Is particularly so at tech companies. Usually, the only reasons an insider buys is because her company requires it as a condition of employment or because she thinks she can make money buying the undervalued stock in her company over time. It is therefore interesting to note that as the stock market has come down hard, insider buying across many industries has increased markedly, especially in the tech area (precisely the area that repulses people the most right now and where traditionally insider buying has been very light compared to insider selling). Services tracking such insider buying/selling report that the insider buying at tech companies is at a multi-year high in relation to the amount of insider selling, and the situation at a variety of other industries is looking promising as well. This insider buying is sufficiently strong that it cannot be explained simply by employment requirements alone.

Another significant factor is how many people, including amateurs, are shorting the market, by selling shares they do not have in the hope of buying them back at lower prices. The problem with shorting is that the potential loss is infinite and uncapped if the stock moves up rather than down. You are then forced to "cover" the short by buying the stocks back at higher prices. This can start an upward spiral for stock prices, as short-covering generates a source of buying that will push up stock prices, which then force more people who are short to cover etc, pushing prices up still further.

Against this surge in demand is diminishing supply (at least once all the mutual fund redemptions slow). There is simply no initial public offerings (a.k.a. "IPO's") being brought to market, because the public has zero appetite for them at this point. In fact, with decimated stock prices, another potential source of demand may be the private venture funds that will take companies private (essentially reverse "IPO's"). Also, consolidation among companies, already under way, will accelerate if stock prices continue to decline, thereby further reducing the supply of shares. All the foregoing supply/demand dynamics, if sustained, will eventually put a floor on the market, and then...reverse its direction.

Valuations Are Reasonable for the Market

Right now, there is a fierce debate as to whether the market is overvalued or undervalued. There are many different ways to judge this question, and an exhaustive review of all possible methods is beyond the scope of this article. We propose a simpler way to get an approximate handle on this question.

It is a given fact that US stocks have averaged about a 10% compounded return per year over the past 75 years or so. Actual annual returns often deviate substantially from this benchmark, but on average they regress around this mean.

To get a sense of roughly where fair value might be for the market, we go back to examine various historical starting points for the market which are generally considered fairly or undervalued, with the benefit of hindsight. We use as our starting points three different time periods coming out of bear markets; in hindsight they are all generally viewed as periods when the market was at least somewhat undervalued. We use the popular S&P 500 as a proxy for the market. By compounding from these various starting points at the average historical rate of 10% per year, we project what a slightly undervalued market level might look like currently, and then compare this reference point with the actual market level.

The first starting point we select is 9/30/80, when the market was at 123.54. Compounding for 22 years at 10% per year would put the index at 1005.65 as of 9/30/02. The second starting point is 10/1/90, when the market was 314.94. Compounding for 12 years at 10% per year would put the index at 988.41 as of 9/30/02. The third starting point is 9/30/94 (1994 was a stealth bear market), when the market was at 462.71. Compounding for 8 years at 10% per year would put the index at 991.86 as of 9/30/02.

Remarkably, despite using very different starting points, the projected values for the market all end up in a very tight range, further proof that the market regresses around an average annualized return of about 10% a year. Short-term returns deviating greatly from this seem to be corrected over time. Given that each of the starting points are considered undervalued market levels, one could argue that each of the projected market ending values would also be considered at least somewhat undervalued. As you can see, the market level of 815.28 as of 9/30/02 is substantially below each of the three above values. Are all the people who say the market is still way overvalued just "piling on?" It certainly appears that way. When we take a longer-term, more normalized view, the market appears quite undervalued at this point.

The "Smart Money" Is Buying, Not Selling

We find comfort in the fact that many investment managers with long-term stellar records have also been buying heavily throughout this downturn. Warren Buffett has also stepped up his purchases in the past 12 months, after sitting on his hands for much of the past three years. This "smart money crowd" appears to be buying with great enthusiasm and conviction. They are happy to take sound investments selling at bargain prices off the hands of those selling in panic. As usual, when the markets go extremes (as we believe they are now to the downside), we are also doing the opposite of the investment masses for our clients (just as we did 3 years ago, during the bubble). We may ***appear*** wrong for a while, but with patience and the passage of time, we think we will again be proven correct in hindsight.

Stay tuned for the next six months as we assess our "prediction!"

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