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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

News About PDV Staff

We are pleased to announce that Ms. Louisa Ho has recently been promoted to the position of Portfolio Specialist. Louisa has an impressive academic background, graduating with high distinction from UC Berkeley with B.A. degrees in both Economics and Statistics. Louisa joined PDV over a year ago, and immediately demonstrated that she is a capable, responsible, diligent and dedicated professional. Louisa is equally proficient with conducting investment research and handling operational issues. From analyzing complex financial statements to dealing with operational matters, she has proven adept at handling a wide range of tasks. Louisa is a tremendous asset to PDV, and we feel most fortunate to have her as part of our team!

PDV SERVICES

Prospective clients often ask how PDV can help them achieve their financial goals and ease their burden of having to worry and think about their financial situation. We can assist you in a wide variety of ways, including the following:

- Provide investment advisory and management services on both a fee and hourly rate basis.
- Design, implement and monitor investment strategy and tailor investment portfolios based on a client's unique financial situation, goals, risk tolerance level and investment time horizon; our aim is to offer ***peace of mind*** to the client by relieving him or her from the burden of having to worry about how to manage and protect his or her money.
- Invest in a variety of securities, including individual stocks and fixed-income investments, as well as mutual funds for clients' benefit.
- Offer asset allocation and diversification strategies to address investment risk.
- Manage fixed-income accounts and shop for price improvement among fixed-income dealers.
- Help employees/plan participants manage 401(k) and other company retirement plan assets, by analyzing available investment options and allocating assets among the most appropriate options.
- ***Help clients reduce or eliminate emotion-based investment decisions***. (See article "Our Own Worst Enemy" on page 2)
- Provide consultation and analysis on self-managed investments or assets managed by other investment managers, by helping clients combat and cut through the hype, myths, misinformation and conflicts of interest perpetuated by dishonest and/or incompetent financial advisors.
- Help clients avoid the potentially harmful effects of trying to accumulate wealth via market timing, by offering a more rational and superior investment framework.
- Provide education to clients, their children, grandchildren and

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other family members regarding financial matters.

- Manage and invest employer sponsored pension/retirement plans for small businesses or organizations.
- Provide consultation and analysis on 529 Education Savings Plans.
- Offer assistance in consolidating accounts to ease administrative burden on clients.

We Can Be Our Own Worst Enemy

By Che H. Lee
President

When it comes to investing successfully over time, we can be our own worst enemy. Human nature generally loathes uncertainty, instability and unpredictability. This desire to avoid these conditions are not only understandable and perfectly natural, but also sensible when conducting many aspects of our daily lives. However, often this desire also results in behavior that is detrimental to our financial health. Numerous psychological studies, delving into areas like myopia, over-confidence, anchoring, herding, and asymmetrical loss-aversion etc., have substantiated and documented this phenomenon.

There are many examples of financially harmful behavior in trying to avoid uncertainty and unpredictability. For instance, we tend to abhor volatility, and often overpay to avoid it, by for example accepting unreasonably low rates on FDIC-insured CD's that don't keep up with inflation, after netting out taxes. We like the illusory comfort of group-think, and tend to invest by consensus, piling into investments whose prices are already sky-high because everyone else are in those same investments. We are frequently attracted to well-established trends and momentum, often not long before they reverse. We are prone to panic-selling when the market drops and prices are lower, and naturally can't stand being left out of market rallies, buying in when the market is rocketing higher and prices are dear. The typical investor tends to buy high, sell low, over and over again.

In *The Psychology of Investing Explained*, Martin Pring succinctly sums up how our natural psychological make-up often results in behavior detrimental to our financial health: "For most of us, the task of beating the markets is not difficult, *it is the job of beating ourselves that proves to be overwhelming, mastering our emotions and attempting to think independently, as well as not being swayed by those around us*. (italics added)."

An investor can let his emotions or temperament get the better of him in many different ways. One of the most common is to expect short-term gratification or results, losing patience absent quick validation or a certain or predictable outcome. When results are not forthcoming in the short run, it is tempting and common to try a different strategy, financial advisor, investment, mutual fund, brokerage company etc.

This desire to change direction if something is not "working out" within a short time comes from, among other things, our desire for instant validation and gratification. However, whether some investment strategy or investment portfolio that is not working is in fact faulty depends on your expectations and time horizon. If you believe that doing well all the time in investing is possible, then naturally you would conclude that changes need to be made once the investment stops working, even if only temporarily.

In fact, no investment strategy, no matter how good, works all the time. Even successful investment strategies will generate alternating periods of strong and more lackluster progress (including possible losses). This is because investment styles, like stocks, go in and out of favor. There may be frustratingly long periods of no or negative progress, only to be followed by another period of unusual strength.

Since perfection is unattainable in investing, anyone expecting this will inevitably be dissatisfied with what they have or whom they are using for financial advice at some point in time. Human nature being what it is, investors will usually make repeated changes into areas that are enjoying success and momentum, usually just in time for those areas to start underperforming, because too many people are piling in.

Making inappropriate changes following inevitable periods of lackluster progress produced by an otherwise sound investment strategy has cost investors dearly. For instance, it has been widely reported that many shareholders of the Fidelity Magellan Fund under the tenure of legendary investment manager, Peter Lynch, 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 out-performance (i.e. buy high). Even Peter Lynch's spectacular career contained some forgettable periods of lackluster progress.

In addition, per the April 2004 issue of Financial Advisor magazine, DALBAR and the Bogle Investment Center found that from 1984 through 2002 the average US equity mutual fund produced a very respectable 9.6% average annual return. However, the average equity mutual fund ***investor*** earned only 2.7% per year. The staggering difference is due to such investor impatiently shifting out of lagging funds before they rebounded and rotating into hot funds before they tumbled. Repeatedly, the average equity mutual fund investor seemed to have made changes that in hindsight greatly hurt him financially. He would have obtained an additional 6.9% per year had he simply stayed put with his investment choice for the entire duration of the measuring period, notwithstanding having to endure some inevitable slow and/or frustrating periods along the way.

Here at PDV, while we are not immune from these psychological pressures, we remain acutely aware of such pitfalls and endeavor to avoid or resist them. ***One of the greatest benefits we provide our clients is to help them navigate through and not succumb to these natural psychological “blind-spots” and tendencies that are detrimental to their financial health.***

Thoughts on Diversification

By Che H. Lee
President

Diversification is one of the most important tenets to successful investing. Simply put, diversification is the idea of spreading your total investment dollars among different investments so that you “don’t put all your eggs in one basket.” The idea behind diversification is to make sure no single investment or small group of investments can irreparably damage your financial situation. Also, diversification is designed to reduce overall volatility, as different investments may not have the same characteristics; therefore some investments might be acting well, while others go through a lackluster period, ensuring that at least some part of the overall portfolio is doing well at all times.

By convention, many investment managers will implement diversification by spreading investment dollars among many different securities, and by making sure a certain portion of the portfolio is invested in different industries and market segments. Often, the allocation among different sectors etc. closely tracks the benchmarks or market indices against which the investment managers are measured. While conventional and popular, this type of approach in our view is more suited to reduce tracking error from the relevant benchmarks than designed to produce the appropriate balance between risk and reward for clients.

Here at PDV, we practice diversification differently. Instead of following some rigid formula as to how many investments we should buy in each industry or market segment etc., we diversify by endeavoring to apply our value-driven investment approach consistently over a portfolio of investments, all possessing financial characteristics that appear to tilt the odds of success in our clients' favor. The idea is that though any one situation with favorable odds may not ultimately work out, a portfolio of securities all seemingly with favorable odds will statistically yield enough winners to generate satisfactory results for the entire portfolio. At times, this means clients may own a lot of investments in one particular area of the market, sector or industry that is particularly out of favor, thereby offering the greatest number of undervalued opportunities. Under these circumstances, clients' investments may at times be more concentrated in any one market segment or industry than typically would exist in other diversified portfolios, at least as defined under the conventional method of diversification practiced by most other investment professionals.

There are other ways we think about diversification. Unless the client desires an all-stock portfolio, we also use asset allocation techniques to achieve diversification by spreading investment dollars among cash/cash equivalents, fixed-income and stock investments. These asset classes tend to move in different directions from time to time and possess different risk characteristics.

Another way we diversify is by assembling client portfolios, one investment at a time, based on a company's operating and investment characteristics. So, for example, steady growth stocks like pharmaceutical companies tend to do better during recessionary times, while cyclical growth stocks like technology companies might do better coming out of a business recession. On the other hand, the progress of special turnaround situations would depend on developments specific to those companies, independent of the business cycle. Assembling a portfolio of investments with these different attributes will generally result in certain investments "zigging" while others are "zagging," increasing the odds that at least ***part*** of the portfolio might do well at any one point in time.

Finally, we also endeavor to achieve diversification for our clients by constructing portfolios with investments possessing different risk/reward profiles. Some are higher risk/higher reward opportunities, while others have lower risk/lower reward qualities. We try to select investments for you that fall within ***the entire risk/reward spectrum***, which together are intended to produce the appropriate risk/reward profile for the entire portfolio.