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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Timing of Stock Purchases

By Che H. Lee
President

As a value investor, we typically buy out-of-favor investments. The negative sentiment engulfing such investments is a double-edged sword. On the one hand, the investments' unpopularity produces the bargain prices that attract us; on the other hand, such out-of-favor investments often drop further before a turnaround takes hold. If the standard is perfection, then value investors are justifiably accused of being "too early" in buying potentially attractive investments.

Of course, ideally everyone would like to catch the bottom in the price of an investment, and see it shoot straight up after purchase. We have no special talents to catch the bottom in price, and expend no effort trying to do the impossible. We buy investments that are "very cheap," without guessing whether their prices have bottomed.

A possible alternative approach is to buy the most popular stocks with their attendant positive momentum. This is very appealing (but in our view costly) for those people who find it unsettling to see the prices of their investments drop after purchase. Temperament accounts for this all-too-natural reaction. These investors tend to lack conviction in what they buy, requiring the illusory safety of consensus to validate their decision immediately. Unfortunately, widely popular stocks have by definition seen their prices bid up, often to overvalued and risky levels.

Professional investors often contribute to this problem. With career pressures, they risk being fired if they do not generate short-term investment progress. It would be career suicide for most professional investors to buy out-of-favor investments. Therefore, their so-called solution is to wait until the "coast is clear" and the turnaround takes hold before buying. However, if and when this occurs, the price will be substantially higher as the market discounts any such positive developments way ahead of time.

One of PDV's competitive advantages is that we screen our clients very carefully. We only accept clients who share our investment philosophy of patience and contrarianism. Having such understanding and supportive clients enable us to take a longer term view of their investments, giving us the luxury to buy out-of-favor investments that tend to turn people off in the short run, but which offer substantial long-term benefits.

To compensate for being early, we tend to spread our clients' purchases over time, thereby averaging down the cost of their purchases. Since we are willing (and our clients allow us) to give an investment at least a couple of years to work out, the subsequent price weakness does not concern us, unless there has been a fundamental, long-term deterioration in the investment's business value.

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Whether a stock dropping after your purchase is of concern depends very much on your investment time horizon and temperament, and how much reserve cash or "buying power" you have. Since we tend to buy investments for our clients in separate blocks over time, we typically welcome additional price declines after our initial purchase to average-down the cost of the total position.

When deciding whether to add to a position with a paper loss, we track the price-to-value ratio ("PTV") of the investment. Price is the current stock price, and value is the business value of the underlying business, which necessarily takes the future into account and depends on certain assumptions. It is useful to come up with a reasonable range of business values based on a probable set of future outcomes.

We like to invest in companies that have PTV substantially under one, selling at prices that greatly discount their business value. This is because stock price and business value tend to converge over time, closing the discount and resulting in appreciation. For additional purchases, we like it best when the value has not deteriorated or perhaps has even increased, but the price of the investment has declined after its initial purchase.

It becomes a much more complicated issue whether to add to an existing position whose business value has dropped after its initial purchase. When this occurs, our decision whether to add to the position depends on the following factors:

1) Did the stock price go down even further than the value of the business, so that arguably the discount has widened rather than narrowed?

2) Is the value deterioration likely temporary or permanent? We are more likely to add if the deterioration is deemed temporary; we will rarely, if ever, add when the deterioration is deemed permanent.

3) What is the risk/reward situation for the particular investment? The more attractive it is, the more likely we will add.

4) How big a position does the client already have in that investment? The bigger his or her existing position, the less likely we will add.

5) By adding to an existing position, are we assuming an overall level of risk that is acceptable (not viewed in isolation, but in the context of the entire portfolio)?

While it is naturally unsettling to see your investments drop in price after purchase, it is part of the price you pay in the short term for pursuing a successful value strategy that has the potential of producing substantial long-term gains.

Technology Companies and the Inventory Cycle

By Che H. Lee
President

Companies can be loosely classified as growth, cyclical or cyclical growth etc., based on their different business characteristics. Cyclical growth companies gyrate up and down based on business or industry cycles, while growth companies increase their revenues and profitability year after year.

While the business of cyclical growth companies fluctuates, typically their operating results tend to reach higher peaks during each successive cycle (with occasional exceptions). In our experience, cyclical growth companies elicit alternating levels of intense greed and fear among investors, providing a fertile ground for market and pricing inefficiencies. With patience and proper focus, it is quite possible to make tidy investment gains repeatedly. Tech companies are one type of growth cyclical investments offering these opportunities.

Many reasons cause the cyclicality in tech companies. One of the most common is the recurring phenomenon of inventory corrections. To understand the concept of an inventory correction, it is first necessary to explain how a typical tech cycle works.

The tech industry is vast, made up of a lot of different sub-sectors and industries. There is a long chain of suppliers, original equipment manufacturers ("OEMs"), distributors, value-added resellers and integrators ("VARs") and end users involved with all tech and electronic products. Some products are sold directly to end-users, but many products are sold first to distributors and VAR's, before ultimately being sold to end-users. Typically, these middlemen who have the most contact with end-users have to guess how much to order from suppliers ahead of actual end-user demand, because suppliers take time to manufacture and deliver inventory. If these middlemen over-estimate end demand, at some point they will stop ordering to let the excess inventory get sold first. Typically, the suppliers are last to know, and order delays or cancellation can be very abrupt. Typically, the middlemen can cancel or delay orders with little or no penalty.

When this happens, suppliers suffer injury on top of insult. First, they have to stop or cut their shipments to the middlemen until equilibrium is restored for inventory levels at the middlemen. This cuts the unit volume sold and hence revenues. Second, many suppliers offer price protection for their products to the middlemen. As tech products lose their value quickly through obsolescence, excess inventory can lose its value very quickly. Suppliers generally have to extend credit to the middlemen for at least part of any excess inventory that cannot be sold, whose value has now dropped in the interim. The combination of these two factors hurt both unit volume and profitability per unit. Hence profitability can drop off sharply and unexpectedly for tech suppliers. Given their fixed-cost operating structure, they can go quickly from high profitability to losses in a matter of a few months.

It is often lucrative to invest in the suppliers during inventory corrections because the investment herd typically does not want to own even the leading suppliers at any price during the downturn. The challenge is to find the suppliers who have strong enough financial condition to survive the duration of the inventory correction and market positions that enable them to thrive when the cycle turns up and the inventory correction is over. The long-term, eventual payout can be potentially enormous, but the wait in the interim can be exceedingly uncomfortable, unsettling, frustrating and testing, as business deteriorates temporarily and the media and all the pundits are negative. Your friends, relatives, colleagues and neighbors etc. are likely to think you have lost your mind owning such companies.

As long as you have patience and fortitude, inventory corrections work themselves out over time and another up-cycle begins. However, the duration of these cycles is extremely difficult to pin-point; you must be vigilant in avoiding the next downturn before it unfolds. While a buy-and-hold strategy is optimal for certain type of growth companies, it is not appropriate for cyclical growth investments.

Investment Opportunities

By Che H. Lee
President

Horace said, "Many shall be restored that now are fallen, and many shall fall that now are in honor." This statement captures well the reality that the economy and companies go through cycles. Regression to the mean is a prevailing and recurring theme in the financial markets. Trends tend to swing like a pendulum around some central marker over time.

For example, take the alternating performance of small and large cap stocks over time. It has been well documented that small and large cap stocks take turns finding favor with the investment masses, resulting in periods of relative out-performance for each. The historical performance of these different asset classes over the past 80 years amply bears this out.

More recently, we had a period in the second half of the 1990's when a narrow group of the largest cap stocks, like Microsoft, General Electric and Pfizer, did spectacularly well, to the exclusion of thousands of smaller cap stocks. Market capitalization-weighted indexes that were propelled by the relative strong progress of these large cap stocks belied the weak market for the vast majority of stocks during that period. A similar episode existed in the early 1970's, when popular, big cap blue-chip stocks known as the "nifty-fifty" dominated market performance. The more popular they became, the more investors chased them.

Since the market bubble burst in 2000, an inflection point was reached and the situation reversed. Small cap stocks have trounced the progress of their larger brethren in the past 5 years. The value gap between small and big cap stocks that existed in the second half of the 1990's has now been completely erased. In fact, it now appears that the higher-quality big cap stocks are more attractive from a valuation perspective.

We are finding most of our newer investment ideas among the big cap sector of the market. These were the very same popular stocks with sky-high prices that we would not go near in the latter part of the 1990's. In contrast, right now these stocks cannot be given away in this market. Many of these high-quality companies have seen their prices go nowhere in the past 5 years, while their earning power has more than doubled. These stocks were vastly overvalued several years ago; now some of them are reasonable, while others are downright cheap.

Though we tend to be skeptical of consensus views, we are quite interested in seeing the collective actions of some of the best value investors in the country confirm what we are seeing among some big cap stocks. For example, Bill Nygren, Wally Weitz, Whitney Tilson and Jim Gipson have all been buying several prominent big cap stocks in the past months.

No doubt there will be a time when small caps will become more attractively valued again, but for now the big cap arena seems the most fertile for finding promising investments.