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PDV *OBSERVATIONS*

Valuation Analysis: A Risk Management, Not a Market Timing, Tool

The stock market is overvalued by any measure. Yet it continues to march relentlessly higher. Yes, there are still undervalued stocks around, but many other stocks are drastically overvalued.

Bull markets make everybody look like geniuses. Novice participants in the stock market, perhaps deluding themselves into thinking they are smart investors rather than in reality traders or gamblers, hop onto popular stocks with strong price momentum without considering valuation or risks involved. In the present "go-go" market, overvalued stocks can and do temporarily get even more ludicrously valued. "Easy and quick profits" are made as long as the risks do not materialize. Having ignored the risks intentionally or because of a lack of knowledge, these people are bragging to colleagues or at cocktail parties about how smart they are and how well they've done.

It's tough to find anybody who's bearish nowadays. Certainly, you'll find very few professional investment strategists from the "sell side" institutions (e.g. brokerage companies) saying anything bearish. Bull markets make lots of money for brokerage companies, so few who work for them dare dampen investors' enthusiasm by bearish comments. The prevailing sentiment on Wall Street seems to be just go with the trend, since one should be able to get out before the top anyway, right?

Under these circumstances, it might be very tempting to throw caution to the wind and abandon valuation levels when analyzing the attractiveness of stocks. ***This would be a huge mistake***. ***In reality, valuations matter -- always have and always will.*** Determining whether the stock market as a whole or a company in particular is overvalued goes to the riskiness of investing. Since successful investing requires, among other things, evaluating risk/return characteristics of investments, valuation analysis is critical to successful investing.

Stock represents an ownership interest in an operating business that earns a return. The stock price of a company will be determined by, among other things, the value of its assets, the return it can earn on the assets deployed and the potential growth of that return. ***Over the long term***, the capital markets are highly ***efficient***, allocating capital to and driving up the stock prices of companies with good earning power and growth prospects. ***Over the short term***, the capital markets are highly ***inefficient.*** Short-term stock price movements are predominately controlled by mass investor psychology that can turn on a dime.

If you examine the long-term historical

Announcing Our Latest Team Member:

*We are very pleased to announce that Ms. Cynthia Medeiros recently joined the **PDV Financial** team. We have known Cynthia for a number of years, and found her to be one of those remarkable individuals possessing an unusual combination of people and technical skills and abilities. We feel most fortunate to have her as part of the **PDV Financial** team. Cynthia is a responsible, diligent, dedicated and very capable professional. She will be a tremendous asset to the **PDV Financial** organization and will help maintain the high level of client service that we always strive to provide.*

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return of the stock market since 1926, you will find that stock market returns have tracked underlying business results of corporate America remarkably well. The long-term average return-on-equity of corporate America is about 13%. U.S. corporations on the average have paid out 50% of their earnings as dividends and reinvested the remainder into their businesses for growth. As a result, companies have grown their earnings by about 6.5% per year. This together with the long-term average annual dividend yield of approximately 4.5% for the market result in the 11% annual *total* returns that the stock market has generated over the long run.

In the past few years, the market has become progressively riskier. Just because the risks have not been exposed in the form of one or more bear markets does not take away the fact that considerable risks exist. At present levels, the market not only has fully discounted the considerable improvements in underlying business fundamentals achieved in the recent past, but also has discounted the expectation that the current optimal business environment of low interest rates and high corporate earnings growth will continue for the indefinite future. Here at PDV, we feel this view is too sanguine and for the reasons explained in the accompanying article entitled "***Warren Buffett Speaks: the Market Listens…to the Wrong Message,"*** this near-perfect economic situation is unlikely to be sustainable.

While valuation analysis tells you nothing about the ***exact timing*** of bear markets, it does serve as an invaluable tool in measuring investment risk. By understanding the level of investment risk, you are able to evaluate whether the potential returns justify your assuming the risk.

Valuation analysis focuses your attention on factors that you can control, such as evaluating and ***managing*** investment risks, rather than on worrying about factors over which you have no control, such as general market movements on a daily basis. Over the long run, excessive investment risks (such as those that exist in the current market) are inevitably exposed. ***You therefore ignore these risks at your peril.*** Valuations matter because eventually stock prices will only go up if ***adequately*** supported by business results. If not adequately supported, stock prices in general will eventually fall.

For example, take Japan's stock market in the 1980's. This market became progressively overvalued as we approached the end of the 1980's. Legendary investors such as Sir John Templeton, having bought into the Japanese stock market many years ago when pervasive gloom and doom suppressed share prices in Japan's market, began aggressively selling his positions as the market reached overvalued levels. He wasn't trying to "time the market," but was making a stock-by-stock analysis of whether the risk/reward characteristics of each particular situation warranted his continuing to hold the stock. As valuation and investment risks escalated, he did what he was supposed to do as a prudent investment manager, namely manage the risk by reducing the exposure. After he finished this process, the market in Japan proceeded to double again over the next two years from the already overvalued levels in 1987!

While Sir John Templeton might have looked foolish in the short term to some for his caution, as he missed out on the spectacular rally between 1987-89, Japan's financial and real estate bubble finally burst in 1989. Nine years later, Japan's stock market is still around ***60% below*** its level in 1989. An overvalued market got even more overvalued, but eventually collapsed back to a level that was more in line with underlying business fundamentals. In time, Sir John Templeton proved that he used valuation analysis appropriately as a risk-gauging tool. By successfully managing risk, he was able to spare his clients from the bursting of a speculative bubble. ***This is a most significant lesson for U.S. investors as they find themselves enjoying one of the biggest bull markets in U.S. stock market history, one that is no longer supported by underlying business fundamentals.***

Warren Buffett Speaks: The Market Listens... to the Wrong Message

If you want to learn the principles of successful investing, there's probably no better way to start than to read some, or all, of Berkshire Hathaway's past annual reports written by Warren Buffett. The clarity and wisdom of his writings are as legendary as his long-term investment record. While we're not suggesting that following his investment principles is the only way to achieve long-term investment success, he has an unparalleled ability to explain the complicated investment process in a simple and easily comprehensible way.

Mr. Buffett chose Saturday (a day when domestic markets were closed) to release Berkshire's 1997 Annual Report on its web site. Probably a lot of people logged onto Berkshire's web site that weekend to see what the "Sage of Omaha" had to say. Our suspicion was that many people were particularly interested in any market-timing tip that he might offer given the elevated levels of the market.

Anyone interested in this was destined to be disappointed as Mr. Buffett has professed on numerous occasions that he has no special ability to time or predict the markets. He said so again in Berkshire's 1997 Annual Report. I can assure you that he is not being coy, disingenuous or modest. He is simply acknowledging the reality that nobody can consistently time the markets. Many legendary investors, such as Peter Lynch and Sir John Templeton, have said the same thing.

As usual, Mr. Buffett made a lot of interesting points in Berkshire's 1997 Annual Report, but the following paragraph particularly captured Wall Street's fancy and attention:

"Though we don't attempt to predict the movements of the stock market, we do try, in a very rough way, to value it. At the annual meeting last year, with the Dow at 7,071 and long-term Treasury yields at 6.89%, Charlie and I stated that we did not consider the market overvalued *if* 1) interest rates remained where they were or fell, and 2) American business continued to earn the remarkable returns on equity that it had recently recorded. So far, interest rates have fallen -- that's one requisite satisfied -- and returns on equity still remain exceptionally high. If they stay there -- and if interest rates hold near recent levels -- there is no reason to think of stocks as generally overvalued. On the other hand, returns on equity are not a sure thing to remain at, or even near, their present levels."

Based on that passage, Wall Street characterized Mr. Buffett as either bullish (or at least not bearish). The market rallied the following Monday, and (except for a few days of intermittent corrections) hasn't looked back.

Here at PDV, we believe there are at least two reasons the quoted passage in Berkshire's 1997 Annual Report was actually bearish, rather than bullish. One has to do with how Mr. Buffett phrased what he ***said*** and the other with what he's ***done.***

First, stock valuations are primarily a function of the level of interest rates and growth in earning power. Earnings growth of corporate America has been spectacular over the past few years, *substantially exceeding* historical trends. Mr. Buffett said that the market is not overvalued if interest rates remain low or fall further <u>and</u> the spectacular earnings growth and profitability continued. We detected a lot of skepticism on his part as to whether the second condition would be met.

He characterized the recent returns on equity ("ROE's") of corporate America as "remarkable" and thought the continuation of this trend is by no means assured. If you examine market history and past economic cycles, you can see why we think he's skeptical.

Historically, businesses making up the stock market have averaged ROE's of about ***13%.*** Currently they are averaging over ***20%.*** Among other things, low interest rates, increased productivity through the use of technology, slower-than-normal growth in wages and benefits and a weak U.S. dollar have all contributed to this. At least some of these trends are beginning to reverse. Also, as profitability improves, companies increase their capacity to try to capture more sales at higher levels of profitability. For a while, all the capital spending drives the economy forward, especially in a low interest rate environment. However, eventually over-capacity results, with supply outstripping demand. Assets become under-utilized and returns drop, resulting in declining ROE's.

In fact, there are early signs that ROE's are dropping as evidenced by, among other things, slower than anticipated earnings growth. In the fourth quarter of 1997, corporate America's earnings growth slowed substantially, and it looks like there will be only marginal year-over-year growth in the first quarter of 1998. Prominent companies, such as Motorola, Intel, Compaq and Disney, as well as a whole host of other companies, have already warned of weaker-than-expected earnings. And yet, the speculative forces currently at work ignored these dire predictions by driving the market up. The brokerage companies, always prone to see the glass as half-full, justify current market levels by projecting a reacceleration of corporate earnings growth in the second half of 1998. This seems particularly perplexing to us at PDV, since the Southeast Asia economic slowdown appears increasingly likely to hurt the U.S. economy as this year progresses.

Second, our view that Mr. Buffett is skeptical that the extraordinarily high ROE's over the past few years can be sustained is also supported by his ***actions.*** Mr. Buffett, who abhors paying taxes or selling stocks, has on several occasions described his favorite stock holding period as "forever!" During past periods of extreme market overvaluation, he ***managed*** investment risks by selling overvalued stocks and allocating a portion of Berkshire's investment portfolio to fixed-income securities. He is wisely unwilling to chase stocks at outrageous valuations simply to remain invested. He's reluctant to invest in stocks, unless there's a substantial "margin of safety" (i.e., the amount the publicly quoted stock price of a company is ***below*** its intrinsic business value.)

To our amazement, Wall Street completely ignored the fact that Mr. Buffett admitted ***selling*** a portion of some of his favorite stocks like Freddie Mac, Disney and Wells Fargo, and some other stocks. Instead, he has been investing in non-equity investments like silver, oil and zero coupon treasury bonds. He also mentioned that in 1998 he continues to sell some of his stocks and invest in non-equity investments. What does that tell you about what he ***really*** feels about the riskiness of the current market?

We believe the market's erroneous reaction to Mr. Buffett's discussion in Berkshire's 1997 Annual Report is symptomatic of the mania enveloping the market and speculative investment psychology currently. In sum, the market didn't listen carefully enough to the real message - ***it heard only what it wanted to hear.***