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PDV *OBSERVATIONS*

NEW ERA, NEW METRICS, *Same Old Story*

The Winter 1999 issue of ***Observations*** reaffirmed the long-term superiority of value investing over momentum "investing", which essentially chases hot-performing stocks regardless of price and, in some cases, regardless of fundamentals. In this issue of ***Observations,*** we will examine what some of the most successful investors of all time have to say about the relative merits of these investment styles. The spectacular long-term investment records of those quoted in this article give their comments unparalleled credibility.

First, let me recap where we are in the value/momentum cycle. Over the past two years, momentum strategies have worked particularly well with respect to a narrow segment of the market, encompassing primarily the technology, biotechnology, Internet and telecommunications areas. (In the past few weeks, this seems to be changing, as many momentum stocks have been crushed, while many value stocks have outperformed).

Outside these areas, lots of high-quality stocks have been irrationally neglected or left to languish or fall substantially. ***The result (until recently) has been a raging bull market in a few select areas and a terrible bear market for the vast majority of the market.***

Throughout market history, momentum and value-driven strategies alternate in their outperformance. Momentum strategies usually do well during speculative periods, where latent risks have not materialized yet, causing people to worry more about being left behind than potential losses. During such periods, the market tends to trade more on emotions, hype and dreams than business fundamentals.

Value-driven strategies usually shine during periods when investors care about risk management (often after previously ignored risks have materialized and hurt them). Under these circumstances, the market trades more on business fundamentals than emotions.

Momentum strategies depend on short-term price movements that are more influenced by transitory factors such as emotions, sentiment, popularity etc. Since short-term market prices are often nonsensical and disconnected from underlying business fundamentals, any strategy (such as momentum "investing") that relies on such near-term price movements while ignoring business fundamentals is unlikely to lead to satisfactory and sustainable long-term investment results. Consider what Peter Lynch has to say on the matter:

"Often, there is no correlation between the success of a company's operations and the success of its stock over a few months <u>or even a few years</u> (emphasis added). In the long term, there is a 100 percent correlation between the success of the company and the success of its stock. This disparity is the key to making money; it pays to be patient and to own successful companies."

--**Peter Lynch** (<u>Beating the Street</u> p. 303)

Lynch is in essence saying that current stock price action tells you nothing about the attractiveness of the stock as an ***investment***, advice that is ***antithetical*** to the principles of momentum "investing".

Lynch, now retired, is considered one of the greatest mutual fund managers of all time, attaining close to 30% average annual compound returns for his shareholders during his 13-year tenure as manager of the Fidelity Magellan Fund.

Despite their current relative strength, momentum stocks are actually risky because they lack the requisite business fundamentals and value to support a price rebound after sentiment inevitably turns negative at some point. While all stocks will experience sharp declines from time to time, undervalued stocks have business prospects that are not adequately reflected in their current price and will likely support an eventual price rebound.

No less an authority than Warren Buffett, widely considered to be the greatest investor of our time, considers short-term stock price movement to be a lousy indicator of long-term investment success, relevant only to short-term traders.

Warren Buffett has compounded annual returns in the upper 20% range for his original partners who invested in his partnership (the predecessor to Berkshire Hathaway) starting in 1956. He emphatically states that the current strength of a stock (i.e. its momentum) reveals nothing meaningful about its likely success or attractiveness as a long-term investment and should not be a basis for investment decisions:

"When the price of a stock can be influenced by a 'herd' on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical."

--**Warren Buffett**

Because short-term price movements are meaningless to the investor looking to accumulate long-term wealth, a strategy or portfolio relying on and benefiting from short-term positive price movement and momentum reveals nothing about its long-term success potential. That is why all investment styles must be tested over ***complete*** market cycles to determine their long-term efficacy.

Advocates of momentum strategies assert that traditional valuation methods don't apply anymore. They pronounce that this is a new era, requiring new valuation metrics that are unfamiliar to those still stuck in the "old economy". Similar proclamations of new eras have been made throughout investment history to justify the unjustifiable during speculative periods. To us at PDV, all this rationalization about new eras and metrics is just the "same old story".

Commenting on a similar speculative period in the 1920's leading up to The Great Crash of 1929, Benjamin Graham had the following observation in his seminal book "Security Analysis," co-authored with David Dodd:

"But the 'new era' commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period."

--**Benjamin Graham & David Dodd)**
(Security Analysis, 1934 Edition)

Graham, Warren Buffett's professor at Columbia and mentor, achieved a long-term record of 20+% annual compound returns, which speaks for itself.

In trying to keep the current technology mania alive, Wall Street is too happy to oblige by announcing higher and higher "price targets" for highfliers, after the herd pushes stock prices past their targets within days. Increasingly outlandish assumptions and new metrics are used to justify the absurd price targets. Graham had this to say in 1934, while commenting on another similar speculative period many years ago:

"The market made up new standards as it went along, by accepting the current price--however high--as the sole measure of value. Any idea of safety based on this uncritical approach was clearly illusory and replete with danger. Carried to its logical extreme, it meant that no price could possibly be too high for a good stock, and that such an issue was equally 'safe' after it had advanced to 200 as it had been at 25."

--**Benjamin Graham & David Dodd** (Security Analysis, 1934 Edition, page 54)

Graham continued to discount the new era argument by remarking:

The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis… Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappeared…. The identical reasoning would support the purchase of these same shares at $200, at $1,000, or at any conceivable price. An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy 'good' stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic."

--**Benjamin Graham & David Dodd** (Security Analysis, 1934 Edition, p. 310)

Momentum "investing" fails over time also because it reflects the ultimate herd-following behavior. ***It confuses what's easy on the emotions with what's attractive as an investment strategy.*** Momentum strategies are easy on the emotions because they hold the promise of immediate gratification/validation via the short-term market price, avoid prolonged uncertainty, require very little patience and create an illusory sense of comfort in consensus thinking.

The fact is that investing by following the herd has never been a sustainable way to achieve long-term investment success. A simple and emotionally comfortable strategy of buying whatever stocks everyone else is buying is hazardous to your financial health. Consider what Benjamin Graham said on this issue:

"Any approach to money making in the stock market which can be easily described and followed by a lot of people is too simple and too easy to last." (emphasis added)

In reality, successful long-term investing requires patience, independent thought, and the willingness and emotional fortitude to go against the herd:

"Our best investments, that in retrospect seem like free money, seemed not at all that way when we made them. When…an investment you think attractive, even compelling, keeps falling, you aren't human if you aren't scared you've made a gigantic mistake. The challenge is to do the fundamental analysis, understand the downside as well as the upside, remain rational when others become emotional…"

--**Seth Klarman**, Baupost Group at Graham and Dodd Breakfast Lecture on November 13, 1997

Sir John Templeton, widely recognized as one of the greatest investors specializing in foreign markets, agrees:

"People are always asking me where is the outlook good, but that's the wrong question… The right question is: Where is the outlook the most miserable?…In almost every activity of normal life people try to go where the outlook is best… But my contention is if you're selecting publicly traded investments, you have to do the opposite. You're trying to buy a share at the

lowest possible price in relation to what that corporation is worth. And there's only one reason a share goes to a bargain price: Because other people are selling. There is no other reason… To get a bargain price, you've got to look for where the public is most frightened and pessimistic… The art of successful investment is counterintuitive. The time to buy is when everyone is scared and you are a bit scared yourself."

Successful investing also requires a willingness to defer immediate gratification and validation, again principles that are totally antithetical to momentum "investing". ***You have to be willing to appear wrong and/or foolish in the short term for long-term gain.*** In discussing what it takes to be successful in long-term investing, the legendary John Neff observed:

"It…requires hard work and the stamina to <u>*appear wrong*</u> *(emphasis added) until expectations pan out."*

When Neff speaks, people should listen. He is considered by many to be one of the greatest mutual fund managers of our generation, because of his 13+% average annual compound returns he achieved for the Vanguard Windsor Fund during his 25-year tenure. In fact, many consider Neff the greatest mutual fund manager of all time because of the outstanding results he achieved over such an extended time period.

In the past few weeks, momentum stocks have begun to implode. With sentiment weakening, some of these stocks have been dropping hard. With inadequate fundamentals to support the prices and the hype evaporating, these stocks are still finding few buyers at substantially lower prices. Consider the recent declines from their highs of a fairly representative sample of former highfliers that symbolized this mania: Red Hat (-74%); I Village (-88%); Dr. Koop.com which came public only a few months ago (-93%); and Etoys (-90%). The list goes on.

I don't know whether the bubble is finally popping for good (since we've had so many false starts in the past months), but much damage has already been inflicted, especially among those speculating on margin.

Perhaps, value strategies will return to favor now that risks have materialized, and many momentum stocks have been exposed as "emperors with no clothes."

Stay tuned!