SPRING 2003

VOLUME 9:1

PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Use a Wide-Angle Lens to View the Markets

By Che H. Lee
President

During these unsettling times, you need to buck the crowd psychology and avoid one of the greatest threats to your ability to reach your long-term financial goals. Some of you might think we're referring to the plunging markets in the past 3 years. The current bear market is certainly frustrating, but not a long-term threat. We're talking about the natural temptation to make long-lasting, significant financial decisions based on current conditions, which are anything but normal. In fact, we have not had a bear market this deep or long since the Great Depression. Markets swing like a pendulum from extreme to extreme, passing through a zone of normalcy from time to time. Financial decisions are best made and financial progress best measured during more normal times, away from the extremes.

Gauging your progress towards your long-term financial goals during a "75-year flood" can lead to undue discouragement, resulting in the irresistible urge to abandon equities altogether. ***To view the temporary interruption of your wealth accumulation during this bear market as a permanent reality is just as misleading as treating the market bubble's transitory positive impact on your wealth a few years back as sustainable and permanent.*** The truth and reality, of course, lie somewhere in-between those two extremes.

Investor myopia has been very much evident throughout market history. During recent times from 1995-99, big-cap growth stocks were all the rage. Index funds, heavily weighted towards these types of stocks by their charter, did spectacularly well for awhile. The investment masses seemed to treat that period as permanent reality, acting accordingly by rushing into index funds. That was a narrow and distorted snapshot on which to base their investment decisions. The flood of cash forced the money managers to keep buying the very same stocks that made the index funds go up in the first place, regardless of price or valuation. This upward spiral was somewhat akin to a pyramid scheme.

This narrow snapshot of the market was followed by the tech bubble from 1999-March 2000. Once there was a perceived new and more exciting investment vehicle, people abandoned index funds in favor of chasing individual tech stocks, until that bubble imploded too. One perceived permanent reality was replaced by another, both of which in hindsight proved to be transitory. For awhile, it seemed the good times would never end, and investors bought with abandon. Those turned out to be highly unusual times, and investors who extrapolated that time period as normal and sustainable have paid dearly.

Inside This Issue:

**Use a Wide-Angle Lens* p.1
**All Sales Are Not Created Equal* p.3
**Preferred Stocks* p.4

Three years later, burnt investors are once again treating the current savage bear market as permanent reality. The natural human inclination to extrapolate the most recent past into the indefinite future is one of the greatest threats to your ability to reach your long-term financial goals. Time and time again, we are prone to take too narrow a snapshot of the market, and base our decisions on how the markets have behaved in our recent memory.

Taking too narrow a market snapshot has caused many to learn the wrong lesson from the past few years. Chagrined, some investors have concluded that the current savage bear market means stocks in general and tech stocks in particular are to be avoided at any price. Somehow, stocks as an asset class are viewed as inherently flawed. This sentiment among the public, perhaps unsurprisingly, was similarly prevalent after every deep bear market in the past. Since bonds appreciated and cash preserved capital during the bear market, shell-shocked investors have decided the relevant lesson is to redeploy funds into those "safe" asset classes. They have acted with a vengeance by pulling more than $120 ***billion*** out of stock mutual funds over the past year, and re-investing it in bond funds as well as CD's and money market funds that are offering historic low yields.

Unfortunately, these investors making the switch learned the wrong lesson. While they think this is the conservative path to take, it is in fact anything but. They are in essence chasing the most recently successful asset classes once again—similar to what many of them did three years ago with respect to tech stocks. The negligible yields on short-term CD's and money market funds mean that these people are in fact losing purchasing power after taxes and inflation. Bonds, particularly those with longer maturities, will lose real and substantial value when (not if) interest rates rise from 40-year lows.

Why are many investors prone to learn the wrong lessons over and over again? The failure to take a wide enough snapshot obscures where a particular market environment lies on the wide spectrum of possible market conditions that swing between optimistic and pessimistic extremes. We tend to over-emphasize the most recent past and draw our conclusions and lessons from that and that alone.

What is the correct lesson to be gleaned from the bubble years? It is that valuation matters. The price you pay for your investment should be low in relation to the underlying value of the operating business. Following consensus blindly and ignoring valuations for both the market in general and individual stocks in particular are what caused the bubble, not inherent flaws with any particular asset class or group of stocks. For instance, there is nothing inherent about tech stocks that makes them categorically attractive or unattractive; it all depends on their ***future*** business prospects in relation to their ***current*** price levels. Tech stocks may be attractive at certain times, and unattractive at other times. Also, some tech stocks may be undervalued at the same time that others are overvalued. They do not have to be mutually exclusive events.

To avoid being distracted from your long-term wealth accumulation progress and remain on track, we encourage you to recognize the natural human tendencies to extrapolate the recent past, and come up with a coping system to resist this. Balance and perspective are key. The market in fact regresses around a mean; normal times will return. Recognizing this and taking a wider-angle view of the markets will help you stay on track with your financial plans without being overly discouraged.

All Sales Are Not Created Equal

By Chad Escarcega
Assistant Portfolio Specialist

Sales (or top-line) growth is the life-blood of a business. Without such growth, a company will find it very difficult to grow its earnings power over time, as there are limits on how much margin expansion can help the "bottom line" achieve sustainable growth. ***However, not all sales are created equal***. A prudent investor knows that a company's level of sales can be affected by many factors. Analyzing the quality of sales is therefore of utmost importance.

One way a company can inflate its sales is by offering credit to its customers. It gives the customer goods or services, but collect little or no cash up-front. Instead, the customer promises to pay at a later date. Although money never changes hands, this credit transaction is counted as part of the company's sales. Hence, more lenient credit policies can often lead to higher reported sales.

The balance owed to a company is recorded in an account on the balance sheet as "account receivables (A/R)." If A/R's are growing faster than sales, it may be a signal that the company is either having trouble collecting its debt owed by its customers or perhaps boosting its sales through overly lax credit policies.

A/R's growing much faster than sales, especially over several quarters, usually portends trouble. Likely, some of those A/R's will turn out to be uncollectible, resulting in a write-down of their value on the balance sheet, with a corresponding hit to reported earnings on the income statement. Functionally, this is equivalent to restating past operating results to eliminate some of the sales that were made on credit. The company's stock price and valuation are likely to suffer as a result.

The fact that A/R's are growing faster than sales does not per se indicate trouble, however. Sometimes, you will see a one-time bump in A/R's that out-strips sales growth before the increase in A/R's tapers off. This often has to do with a change in the company's factoring policy.

Factoring involves the sale of A/R's to a third party at a discount. Selling its A/R's gives the company immediate cash and transfers the risk of default to the buyer of its A/R's. Factoring is not always advantageous to the company selling its A/R's. Sometimes, the benefit of receiving cash up-front is outweighed by the size of the discount that it has to accept on the transfer price; at times, in hindsight, the company would have been better off not factoring at all.

If a company's A/R's experience a bump because the company decides it is no longer advantageous to do as much factoring due to overly large discounts demanded by the marketplace, it is not necessary a bad thing. Provided the company has not overly relaxed its credit policies and the customers continue to pay on the increased level of A/R's retained on the company's books, the increased A/R's may not indicate any impending trouble.

The lesson for the prudent investor is that a company's financial statements are full of interrelationships. No financial metric should be viewed in isolation. To get a comprehensive picture, one needs to act like an accounting sleuth, delving deeply into the numbers and understanding these interrelationships. Sales growth alone isn't necessarily a positive indication of a company's well being if its A/R's are growing at a faster rate. On the other hand, A/R's that experience a bump before leveling off might be due to a welcomed and prudent change in factoring policy.

Preferred Stocks

By Adam Cheng
Assistant Portfolio Specialist

Preferred stocks, often laboring in relative obscurity compared to their common equity and bond brethren, can make attractive investments under appropriate circumstances. In general, there are four types of preferred stock: cumulative, non-cumulative, participating and convertible. Cumulative preferred stock allows dividends to accrue in the event the issuer does not make timely payments. These unpaid dividends are called dividends in arrears and must be paid by the company before making any dividend payments on the common stock. Non-cumulative preferred stock does not offer the benefit of such accruals. If the issuer decides that it cannot make payments, the company is not obligated to pay the delinquent dividends at a later time; however, no dividends can resume on the common stock without initiating them again on the preferred stock first. Participating preferred shareholders can receive, in addition to regular dividends, additional payments based on certain specified circumstances. Lastly, convertible preferred stocks can be converted into common stock at a predetermined price.

Other features common to most preferred securities include the following: 1) quarterly dividend payments, 2) $25 per share par value, 3) a priority claim on corporate assets that are junior to bondholders, but senior to common stockholders, 4) dividends that are fixed in amounts, and 5) no voting rights.

Nowadays, many preferred stocks are issued in the form of Trust preferred securities that are put together by Wall Street. These structures allow the issuing companies to treat the dividend payments as deductible interest, thereby reducing the after-tax cost of this form of financing. Consequently, the issuing companies can at times afford to pay somewhat higher yields than straight preferred stocks to attract investors. On the other hand, this type of Trust preferred securities is less desirable to taxable corporations, which are a primary source of demand for straight preferred stocks, since Trust preferred securities do not offer dividends-received exclusion tax benefits to such corporations.

The market for preferred stock is much smaller than that for bonds or common equities. As hybrid investments, preferred securities can also be confusing to understand. These two factors mean that preferred stock can be inefficiently priced from time to time, offering attractive investment opportunities. While preferred stock will react adversely to a rise in interest rates like bonds, their generally higher yields mean their interest rate risk is more muted.

Like any investment, there is risk associated with preferred securities. The issuing company has discretion whether dividends will be paid. However, it is not in the company's interest to suspend payments for capricious reasons, but only as a last resort. Suspending dividends could potentially jeopardize future sources of capital funding. It tarnishes the company's credibility and makes future debt and equity offerings, if available at all, possibly cost-prohibitive.

As with any fixed-income investment, credit analysis is important prior to investing in preferred stocks. Cash flow should be ample to comfortably cover fixed-charges that include imputed interest portion of operating rental, taxes due, debt service on all senior debt and all preferred dividends.

Copyright 2003 **PDV *Financial Management***, 10680 West Pico Boulevard, Suite 400, Los Angeles, CA 90064. Phone: (310) 559-0898 / Fax: (310) 202-9170 / E-mail: pdvfinmgt@aol.com. All rights reserved. The contents of *Observations* have been compiled from data and sources believed to be reliable, but are not guaranteed as to accuracy or completeness. PDV (and its clients, employees and associated individuals) may, at times, have positions in the securities and investments discussed in this newsletter, and may make additional purchases or sales. This publication is intended to be a source of general information regarding the financial markets, and discussion of specific securities is not (and should not be relied upon as) specific investment advice or recommendation for any reader to buy or sell such securities. Readers should consult qualified financial advisors regarding their particular situations prior to taking any specific action.