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PDV *OBSERVATIONS*

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Making IRA Contributions to Save Taxes

By Che H. Lee
President

As we face the unpleasantness of yet another tax season, our attention should naturally turn to ways to reduce our taxes. One of the easiest ways to do this is by making IRA contributions. There are many types of IRA's: we are referring to making contributions to a ***Traditional* IRA** in this article.

It is a common perception that one is not eligible to make contributions to a Traditional IRA if one is already covered by a retirement plan at work and/or one's salary exceeds certain limits. To explain why this is not true, it is useful to briefly review the benefits of making Traditional IRA contributions.

Traditional IRA contributions offer two sets of potential tax benefits: 1) your ability potentially to deduct the entire or a portion of the contribution ("front-end" benefits), and 2) tax deferral on any returns from such contributions ("back-end" benefits). Contrary to common perception, neither coverage by a retirement plan at work nor high salary levels affect your right to make an annual contribution and enjoy at least the back-end benefits of tax deferral. In fact, the only conditions to your ability to make a Traditional IRA contribution are the following: you have earned income that at least covers the contribution amount (spousal IRA's are an exception to this condition and beyond the scope of this article); and you have not reached 70 1/2 years old by the end of the tax year in question.

Coverage by a retirement plan at work and high income levels only affect your ability to deduct your contributions and enjoy the front-end tax benefits. Your ability to deduct contributions to a Traditional IRA depends on several factors: filing and marital status; whether you (or your spouse) is already covered by a retirement plan at work; modified adjusted gross income levels and whether you are receiving social security benefits. Deductibility phases out based on the interplay among these factors.

If your situation negates your ability to deduct your contributions, it is *typically* preferable to make non-deductible contributions to a Roth IRA instead. However, unlike Traditional IRA's, high income levels will ***prohibit*** you from making any Roth IRA contributions.

If your salary makes you ineligible to make Roth IRA contributions, you should 1) nevertheless make contributions to a Traditional IRA (even if they are not deductible) to get the back-end benefits, and 2) file IRS Form 8606 with your tax return, to avoid such after-tax dollars from being taxed again at the time of IRA withdrawals.

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Tax legislation passed in 2002 increased the prior Traditional IRA contribution limits. For 2004 and 2005, the limits are $3,000 and $4,000, respectively. Anyone who is at least 50 years old by the end of the tax year in question may add $500 to these limits. Total contributions to Roth and Traditional IRA's together cannot exceed these limits. 2004 Traditional IRA contributions can be made up to April 15, 2005, while 2005 contributions can be made at any time up to April 15, 2006. The earlier the contributions are deposited, the earlier any returns will be shielded from tax. This is a valuable tax break that you should be taking advantage of every year.

Definition of Risk

By Che H. Lee
President

Investing involves many different types of risks. Here at **PDV**, we worry about ***risk of permanent loss of capital***, rather than the ***risk of temporary or quotational capital loss.*** Permanent capital loss results from diminution in a company's business value on account of deteriorating operations that are likely to persist over time, while temporary or quotational capital loss results from inevitable market fluctuations that generate "paper losses." While less important in our view, the latter causes the most strain on people's emotions, when they see the value of their investments and wealth gyrate with the vagaries of the market, often causing them to make investment decisions they later regret.

These different views of risk can be traced to the fact that for most people, risk involves some vague notion of the possibility of loss, but different people will ascribe varying meaning to the concept. Often omitted in the definition or analysis of risk is, for example, the issue of time horizon. Buying a high-quality stock at a reasonable price might be risky for a day-trader whose time horizon is only one day; the markets are so irrational and random over the short run that anything can happen to the price of a high-quality stock in a single day. Buying the same stock to hold for ten years or more makes the same purchase a lot less risky.

Marty Whitman, the legendary value investor, has one of the most intelligent ways of viewing risk. He thinks that the word "risk" should not be viewed in isolation, but one should always be precise in defining what ***type*** of risk one is talking about. Whitman therefore is careful to use adjectives to describe what type of "risk" he's discussing, whenever he's opining on this subject.

As discussed above, there are in fact many different types of risk when it comes to investing. ***These risks are sometimes mutually exclusive; trying to avoid one would necessarily mean that you will have to assume another***. For example, ***the risk of losing purchasing power*** is one of the most subtle and yet important risks that inflicts those who "safe-keep" their money in a bank account. With the eroding effects of inflation and taxes, depositors are in fact generally losing purchasing power over time ***after taxes and inflation.***

Market risk is the risk that the publicly-quoted prices (but not business values) of your investments fluctuate along with the uncertain and unpredictable nature of the markets. It is mostly a short-term concern, as stock prices and underlying business values tend to converge over time. ***A long-term investor might welcome market risk, so that she can buy in at attractive prices***.

As can be seen from these different types of risk, a simple notion of risk would not adequately capture the complex nature of risk trade-offs. One must be clear what exactly is the risk being managed. All prudent efforts to address or manage risk will usually require making conscious choices that will exchange one set of risks for another. Having these distinctions clearly in mind will increase the odds of success for investment decisions.

Normalized Earning Power

By Che H. Lee
President

The concept of a company's normalized earning power is central to reaching a proper valuation of a company's worth. While normalized earning power cannot be determined with absolute precision, it is critical that efforts be made to estimate its level.

The idea of normalized earning power derives from the fact that almost all companies have some cyclicality to their businesses; their operating results tend to bounce around from year to year, even though the long-term trend might be up. When valuing a company, it is important to pick a level of earnings that the company can realistically ***sustain*** over time. Choosing an earnings level created during a particularly robust (or poor) operating period for the company will give a distorted picture of the level of sustainable earnings for the company during more normal times.

The foregoing issue is highlighted when the price-to-earnings ratio ("p/e ratio") is used, among other valuation tools, to assess the attractiveness of a potential investment. The p/e ratio is simply the current market price of a stock divided by its actual (or estimated) earnings per share over a certain period.

The proper way to use the p/e ratio as a valuation tool is to adjust the "e" part of the equation to normalized earnings rather than reported earnings according to generally accepted accounting principles. Normalized earnings are reported earnings that are ***adjusted*** for the impact of events properly considered transitory or non-recurring in nature. Long-term investors should focus on normalized earnings rather than accept earnings that companies report on their face without any such adjustments. Failure to focus on normalized earnings could distort the "e" part of the p/e ratio, leading to misleading conclusions about whether a stock is undervalued.

Knowing how to make these adjustments requires a good understanding of the company's business and the industry in which it operates. Most of our clients do not have the time or interest to do this. Here at **PDV**, we undertake this work as part of our research efforts in discovering undervalued securities for our clients.

Valuation as Risk Assessment

By Che H. Lee
President

Valuation techniques are critical for analyzing and assessing the levels of investment risk, but they are ineffective as market-timing tools. Why?

It is incontrovertible that the stock price and business value of a company tend to converge over time. The collective business value of all companies making up the stock market has been accurately reflected in the progress of the stock market in the long run. The historical return of the stock market since 1926 has tracked underlying business results of corporate America remarkably well.

The long-term average return-on-equity of corporate America is around 10-12%. U.S. corporations on average have paid out around 50% of their earnings as dividends and reinvested the remainder into their businesses for growth. As a result, companies have grown their earnings by around 5-6% per year. This, together with the long-term average annual dividend yield for the market and price-earnings multiple expansion, result in the roughly 10% compounded annual *total* return that the stock market has generated over the long run.

When the stock price of a company is higher than its business value, there is the risk of depreciation as the stock price drops to meet the lower business value over time; alternatively, the stock price might stagnate while the business value catches up. Conversely, when the business value exceeds the stock price, there is potential for capital appreciation as market price moves up to converge with business value, at the same time mitigating the risk of a persistent decline in the stock price. ***In this way, valuation is a very powerful tool for evaluating and managing risk.***

On the other hand, it tells us very little about ***when*** price-value convergence will occur, and therefore is fairly useless as a timing tool. That is why we often see overvalued stocks march relentlessly higher for awhile, while undervalued stocks can languish for a frustratingly long period of time. This is especially prevalent during speculative "go-go" markets. How long it takes for price and value to converge in a particular situation depends on a complex list of factors, including confidence levels, investor psychology, emergence of high-profile catalysts that capture the fancy of the investment public etc.

Despite the impotence of valuation techniques as a timing tool, they nevertheless represent an invaluable way for properly assessing long-term investment risk.