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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

What Makes PDV Different from Other Firms?

By Che H. Lee
President

We are often asked how **PDV** is different from the vast majority of other fee-based investment advisory companies? The major difference lies in our respective incentive systems. In short, many other investment advisory firms are subjected to client pressures to produce short-term investment results, and most of them succumb to these pressures by failing to screen their clients. Here at **PDV** we resist such pressures at all costs. We accomplish this by being willing to control our growth and refusing to take on any client who insists on seeing short-term progress. We feel so strongly about this that, over the years, we have given up substantial business by refusing to take these types of investors on as clients.

How does this phenomenon commonly known as the short-term performance "rat race" come about? It is a natural human tendency to dislike uncertainty, especially when it comes to matters of money. Psychologically, we tend to address this feeling of discomfort by seeking immediate validation and social proof via consensus. This is well-known within the field of psychology. We want to avoid feelings of regret that somehow we may have made an investment mistake if the price goes down *the next day*. We particularly welcome social proof -- general and widespread agreement among others -- that the investment is a good one. Nobody wants to feel like a financial patsy and a lonely one at that.

Many investment advisory firms that cater to retail investors confront this pressure. These firms understand that if their clients don't get instant gratification, they are likely to move on to other professionals. These investment professionals are therefore forced as a matter of business reality to focus on producing short-term results to appease and retain clients.

Investment advisory firms that cater to institutional clients are under even more pressure to produce short-term performance. Institutions exemplify the worst in investor herd behavior, as

News About PDV Staff

We are pleased to announce that Ms. Louisa Ho was recently promoted to *Senior Portfolio Analyst*. A high honors graduate from U.C. Berkeley with B.A. degrees in Economics and Statistics, Louisa joined PDV over 6 years ago and is equally proficient with conducting investment research and dealing with operational matters. Louisa is a tremendous asset to PDV and our clients, and we look forward to her being an integral part of our team for years to come!

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they generally are loath to select investment advisory firms that do not follow conventional wisdom when investing. Since the investment advisory firm knows this is the client's expectations, they too will get with the program by following the consensus as the safe way to preserve the client relationship.

The ultimate result of both this retail and institutional client pressure being brought to bear on investment professionals is quite predictable -- most of them tend to move en masse with little creativity or independent thought, in and out of the same securities at roughly the same time. The only way an investment advisory firm can rationally endeavor to produce good short-term performance is to chase whatever happens to be "working" in the short run. "Working" in this case means upward movement of the stock price, even if it happens to be a lousy or overvalued company.

This type of investing style that focuses on producing short-term performance, in our view, is destined to produce mediocre investment results at best over time. At worst, it leads to total disaster. Here at PDV, we resist and reject this type of widespread investing style categorically.

Benchmarking

Related to the issue of short-term performance is the fact that many investment advisory firms are saddled with the mandate that they perform in line with some chosen benchmark, which is often some market index or composite of market indices. Their incentive system usually provides large penalties for lagging such benchmarks, while providing for a smaller reward for outperforming such benchmarks. Because to many, the reward of extra compensation that comes from outperformance would not justify the risk of the substantial penalties for under-performing their benchmarks, these investment professionals spend their waking hours doing their best to track their benchmarks, as opposed to doing what's best for their clients over the long run. Tracking benchmarks involves determining what securities make up the benchmark index and in what weightings, and then buying the same securities in similar weightings for client portfolios. Instead of investing in what is most appropriate for clients, these investment advisory firms are investing according to some arbitrary reference point.

This problem is particularly acute for investment advisory firms catering to institutional clients, who hire "consultants" to select and monitor investment managers. Most of the benchmarks are chosen by or creations of the consultants, who have to justify their huge consulting fees by creating the illusion of scientific order via these benchmarks. Without benchmarks they have a much smaller role to play and much lower fees to collect.

Managing money according to benchmarks guarantees mediocrity at best. Why? Because benchmarks tied to various market indices are nothing more than the result of the collective buy/sell decisions of all market participants at any one time and their impact on prices of stocks that in the aggregate make up the various market segments. ***From this perspective, by definition the progress of the market at any time is defined primarily by what the vast majority of market participants are doing with respect to their investment decisions. If you follow the herd, you become part of the market. This is in fact how most money is professionally managed.*** In contrast, we are most likely to go against, rather than along with, the investment herd, because we strongly believe this con-

trarian approach is much more in our clients' long-term interests.

Investment advisory firms that give in to this type of retail and/or institutional pressure for self-preservation (and most do) will see their primary job as serving the twin related purposes of producing short-term performance and minimizing any variance of their client accounts from the progress made by the market or applicable benchmarks; in this sense, they are mostly focused on reducing "tracking error," as opposed to actually doing what is best for the client in the long run. It is for this reason that it is widely reported and known that most investment professionals produce wealth accumulation progress that lags the progress of the stock market over time. This is because the vast majority of investors by definition constitute the market, and their progress is essentially the market's progress, minus management fees and transaction and other costs.

Here at **PDV**, we would respond in the same way for self-preservation if we accepted this type of flawed incentive system or chose to do business with clients who put this kind of pressure on us. Because we do not believe this is a productive way for people to accumulate wealth over time, ***we have decided as a firm to find and select clients who allow us to operate under a different incentive system -- one that allows us to forego instant gratification in search of greater long-term benefits for our clients***. By doing this, our clients allow us to invest differently than the vast majority of investors, which by definition means their investment progress will also be different, and hopefully superior, over time. *(This article, in substantially identical form, appears on our website.)*

We Are Our Own Worst Enemies

By Louisa Ho
Senior Portfolio Analyst

During the 2008-2009 financial meltdown, investors fled equities and bolted for the safer bond market on an astonishing scale. This is totally predictable from a behavioral standpoint. Most seem incapable of buying low, selling high. Data from research firm Trim Tabs Research show that for calendar year 2009, investors withdrew a net of $35 billion from stock mutual funds, while pouring a net of $421 billion into bond funds. The Investment Company Institute, a national association of U.S. investment companies which also tracks mutual fund flows, similarly reported that from the beginning of last March to the end of January 2010 in the midst of a soaring market, U.S stock mutual funds nevertheless experienced a net outflow of $25.8 billion, while the bond mutual funds received a net inflow of some $368 billion.

Despite the stock market's impressive rally since the lows in March 2009, investors continue allocating most of their new money into bond mutual funds. And they are doing so despite the massive inflows driving up bond prices so far and so fast that there is an increasing concern bonds could be the next asset class to suffer a downturn. In fact, according to Morningstar's most recent data, taxable bond funds received the highest inflows among all major asset classes during February in the amount of $19.8 billion. Bond fund giant PIMCO was the top recipient of new money in February. In contrast, U.S. stock mutual funds was the only asset class in February that recorded a net outflow, marking its fifth net outflow in the past six months!

The recent dumping of stock funds at the market bottom and piling into bond funds despite sharply higher prices are evidence of investors' continuing tendency ***to sell low and buy high***. As value investor Bill Miller pointed out in his market commentary from last October, historical data show that "every time stocks have performed poorly for 10 years, they have performed better than average for the next 10 years, and they have beaten bonds every time by an average of 2 to 1, yet investors can't put money in bond funds fast enough, and continue to redeem equity funds."

In its 2009 annual study of mutual fund investor behavior, research firm DALBAR studied how investors reacted to market changes in the 5 years ended December 31, 2008 by comparing the mutual fund flows and market performance during that period. The results show that investors poured cash into mutual funds when market returns rose and were quick to redeem their shares when market returns fell. During the 20-year period ended December 31, 2008, the average holding period of both stock mutual funds and bond mutual funds ranged from 2.5 year to 4.3 years. This relatively short average holding period further shows investors' persistent behavior in timing the market and their lack of emotional wherewithal to ride out inevitable rough periods. The study also used a "guess right" ratio to measure investors' success rate on market timing. The ratio measures how often the average equity investor correctly "guesses" the direction of the market, based on mutual fund inflows and outflows between 1988 and 2008. The investor is deemed to have guessed correctly when there is either a monthly net inflow followed by a market rise, or a net outflow followed by a downturn. The guess right ratios were lowest in periods of market declines, meaning investors were particular bad at timing the market during market downturns; they ended up selling with the erroneous expectation that the market would not turn around, when in fact it ultimately did. The results from the guess right ratios also show that investors' risk tolerance tends to increase in exuberant times and decline during market downturns. DALBAR concludes that investors have a strong tendency to panic during market declines. Panic spawns bad decisions, which in turn compound investment losses in an already falling market.

How did investors' attempt to time the market and other emotional behavior affect their returns? The average investor substantially underperformed the market indices over time. Over the 20 years ended December 31, 2008, equity mutual fund investors earned an average annual return of 1.87%, while the S&P 500 Index earned an average annual return of 8.35%. Fixed income fund investors earned an average annual return of 0.77% over the same 20-year period, while the benchmark Barclays Aggregate Bond Index earned an average annual return of 7.43%. In both cases, the opportunity cost from poor market timing amounts to almost 7% per year compounded! This, over an investment lifetime, could well be the difference between a secure retirement and running totally out of money.

The reality is that the innate tendency to act upon emotions more often than not leads investors into making buying and selling decisions at the worst moments. Instead of buying low and selling higher, the average investor tends to chase returns in bull markets and to not stay invested during bear markets. Human nature is difficult to fight or change. To improve their returns over time, it is critical that investors come up with a coping system, especially for turbulent times, to avoid engaging in irrational behavior and to remain disciplined in their investment decisions.

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