SUMMER 1996 VOLUME 2:2

PDV *OBSERVATIONS*

Recent Market Developments

Following the cue from the bond market (which has retreated substantially since late February), the stock market also has pulled back substantially since late May. Some of the correction in the stock market was justified (since it has been overvalued as a whole for quite some time), and welcomed in the sense that it flushed out some of the rampant speculation.

In recent days, the pull-back has accelerated with the NASDAQ index at its worst intra-day level dropping almost 20% from its peak reached less than 2 months ago and the S&P 500 and Dow indexes dropping around 10% from their respective peaks this year. These indexes don't really begin to tell the whole story, as some individual stocks have fallen 50-80%. For example, indexes made up entirely of technology stocks have experienced even more substantial declines. "Where is the market going" has become an ever popular question.

We have to thank the momentum "investors" because their indiscriminate and mindless selling has set off a chain reaction that is unduly depressing the stock prices of some outstanding companies.

As many of you know, here at PDV we don't spend alot of time trying to answer this question or forecast the markets. Despite the abundant prognosticators claiming to the contrary, we don't feel anybody can time the market correctly *on a consistent basis*. While we do have an *informed opinion* regarding the valuation level and relative attractiveness of the market on a risk/reward basis, this does not mean we can consistently predict what the market ***will*** do.

Frankly, we think our clients are better served by our spending our time researching companies one-by-one and investing their funds in undervalued companies with good long-term business prospects. For our clients invested in mutual funds, we seek those funds that invest in good solid companies/businesses with good risk/reward characteristics. We shun funds that are overt or disguised market timers.

Since the inception of ***Observations***, you might have noticed that we have spent no time reporting on market developments (unlike many other newsletters out there). So why do we choose to write about this subject now? It is because while many have perceived the recent market pull back as bad news, it is actually ***good news*** and we want to explain why this is the case.

We have to thank the momentum "investors" because their indiscriminate and mindless selling has set off a chain reaction that is unduly depressing the stock prices of some outstanding companies. (Please see the enclosed Wall Street Journal clippings

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regarding this mindless herd-oriented strategy that totally ignores business fundamentals.)

Those who buy or sell indiscriminately *regardless of price* (see enclosed article on U.S. Robotics) treat stocks as just pieces of paper to be bought when there's momentum, and sold when momentum vanishes. The underlying value of the businesses supporting stocks has little relevance to these momentum "investors". In reality, stocks have value because the companies issuing the stocks can generate a profit or return on the capital invested. It is therefore much more important to focus on the *business* than the short-term movement of the stock. ***If the performance of the business comes through, the stock price should (and in most cases will) follow eventually.***

Because of the chain-reaction initiated by the momentum "investors", even undervalued companies with good long-term prospects have *temporarily* suffered *quotational loss.* However, their stock prices will not stay down and in fact will continue to appreciate over time provided their business operating results come through. For these companies (whose stocks are the type we try to buy for you), the temporary pull-back in their stock prices is not only harmless, but actually offers attractive opportunities by allowing long-term investors to buy shares in a good business at bargain prices. On the other hand, over-hyped stocks with poor prospects that were selling at 100 times earnings (or even sales) are *still* not buying opportunities even after their steep declines. They will stay down without ever recovering to their former lofty levels because the bubble has burst, the hype is gone and there are insufficient business fundamentals to justify such a recovery.

It is in times of other people's panic and fear that attractive long-term investment opportunities are created for you. Those who are going to be successful investors in the long run will be ***selective*** in picking through the beaten-down stocks on Wall Street. Some companies have become undervalued bargains and screaming buys, while others *continue* to be overvalued dogs even after the steep declines in their stock prices. Rather than focusing on the market, here at PDV we are intensifying our efforts to take advantage of the bargains created by the recent market pull-back and make the right selection for our clients.

Comparing Bond Yields:
There's more (alot more) than meets the eye (Part II)

In Part I of this article which appeared in the Spring 1996 issue of ***Observations***, we introduced a number of yield measures for evaluating the attractiveness of bonds. Despite its imperfections, we concluded that the ***yield-to-maturity*** ("YTM") is the best yield measure to use when comparing the relative attractiveness of bonds with different characteristics.

You might recall that we had used an example to illustrate how to evaluate bonds appropriately. The example involved having to decide between Bond A (7% coupon yield) and Bond B (5% YTM). To make the appropriate selection, we decided it was necessary not only to compare the YTM of Bonds A and B, but also to evaluate whether any yield difference is justified.

Part II of this article examines the most significant bond features that 1) affect bond yields, and 2) may account for yield differences among competing bonds. Part III of this article, to be published in the Fall 1996 issue of ***Observations***, will conclude by discussing some macroeconomic and market factors that impact bond yields and selection.

Continuing with our example, let's assume that Bond A has a 5.1% YTM. Since this exceeds Bond B's YTM by 0.1% (or 10 basis points in bond parlance since 1% equals 100 basis points), Bond A *appears* to be the more attractive bond, *all things being equal.* But this is only the beginning (and not the end) of the inquiry.

By this time, you might be quite surprised that bond investing sounds alot more complicated than you may have been led to believe. Your feeling would be warranted.

The next question is whether the 10-basis point difference in YTM can be explained by any difference in the respective features of the two bonds. This involves examining the bond features that are the primary determinants of bond yields: credit rating, maturity, liquidity and special features such as call protection and sinking funds.

First, the creditworthiness of most bonds is rated by rating agencies such as Standard & Poor's and Moody's. These ratings are very important to the entities issuing the bonds because they are heavily relied upon by investors. Getting high ratings from the agencies means lower borrowing costs for the bond issuing entities as they are able to offer lower yields on their bonds. This is because investors are willing to accept lower yields from creditworthy companies that are more unlikely to default. (Please see the table on page 4 describing the ratings.)

Second, under normal economic circumstances, longer term bonds generally yield more than shorter term bonds. Investors demand higher yields for tying up their money for a longer time and accepting greater exposure to possible increased inflation or higher interest rates in the interim.

Third, bonds that have big *floats* (i.e. those issues that have a large amount of bonds outstanding and usually are actively traded) tend to have lower yields. Investors must be tempted with higher yields before they are willing to buy bonds which they may have more difficulty unloading should they decide to sell before maturity. Illiquid bonds also tend to be unpopular with institutional investors, thereby reducing demand and increasing yields.

Fourth, special bond features such as sinking funds, as well as put and call options will also impact bond yields. For the purpose of this article, let's discuss the most significant of these, which is the nature of the call protection, if any, for the bond.

When a bond is callable, it means the bond issuer has the right under certain circumstances to repay the bond prior to its maturity. This will usually occur at a time of declining interest rates, when it is unfavorable for you since you have to reinvest the bond repayment at lower interest rates. To induce investors to accept this risk, issuers of callable bonds have to offer higher yields than issuers of non-callable bonds.

To properly evaluate the relative merits of Bonds A and B, it is necessary to determine whether the 10-basis point difference in YTM is caused by any of the above factors. For example, Bond A may not be the more attractive investment if its higher yield is due to inferior credit quality, liquidity or call protection, or a longer maturity. Any of these features would make Bond A an inferior bond, and the question then becomes whether the 10-basis point yield increase is enough to compensate you for accepting the inferior bond characteristics.

By this time, you might be quite surprised that bond investing sounds alot more complicated than you may have been led to believe. Your feeling would be warranted. Bond investing appears deceptively straight-forward, but in reality is quite complicated. Among other things, it necessitates understanding different yield measures, comparing YTM's, and evaluating whether differences in bond features justify different YTM's.

For simplicity sake, let's assume that Bonds A and B are similarly rated, have comparable liquidity and maturities, and neither is callable. Now, you might conclude

that Bond A has to be a better investment because it's comparable in all significant aspects to Bond B, and yet has a higher YTM. But wait. It turns out that there are also important macroeconomic and market factors that impact bond yields. Because these factors exist independent of features that are peculiar to the bonds themselves, it is important to broaden one's analysis to include macroeconomic and market conditions. We will do this in Part III of this article.

DESCRIPTION OF BOND RATINGS

Moody's	Standard & Poor's	Meaning
Aaa	AAA	Highest quality
Aa	AA	High quality
A	A	High-medium quality
Baa	BBB	Medium quality
Ba	BB	Some speculative elements with moderate assurance of future performance
B	B	Currently performing; but future performance uncertain
Caa	CCC	Low quality
Ca	CC	Highly speculative
C	C	Lowest quality
D	D	In default

Shaded categories are considered investment-grade, while all others are considered non-investment grade or "junk" bonds. Moody's also uses numerical modifiers (1, 2 and 3) while Standard & Poor's uses (+) or (-) to denote further rating distinctions within each rating category from Aa/AA and lower.

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