SUMMER 1997 VOLUME 3:2

PDV *OBSERVATIONS*

The Good, the Bad and the Ugly

The market has continued to exhibit multiple personalities: the good, the bad and the ugly. We want to give you an update, so you know which "personality" you are confronting when evaluating investments in different sectors of the market.

The "Good": The "good" refers to the performance of those overvalued large blue-chip companies that the investment herd currently loves to buy regardless of price or valuation. These companies, many of which have fine financial and operational histories, are perceived (erroneously in our opinion) as "safe" investments. The investment crowd loves to buy these companies because they have so far offered seemingly instant gratification and, in some cases, illusory validation of investment acumen.

In case you think it is the unsophisticated getting sucked into buying these overvalued stocks, you might be surprised to discover that in many cases it is the professional investment managers who are buying these types of investments. While some of them have readily admitted on record that these investments are grossly overvalued, they can't stand being out of step with the crowd, for fear of criticism by clients or superiors. They feel compelled to participate in and perpetuate this mania because it's where the momentum and "easy money" are currently.

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PDV STOCK-PICKING PRINCIPLES

Here at ***PDV*** we strongly believe that successful investing requires <u>p</u>atience, <u>d</u>iscipline and a <u>v</u>alue-orientation. While there are many different investment styles that can lead to long-term investment success, we feel that such styles will at least share the above characteristics. We have developed a set of stock-picking principles that guide our selection of stocks for our clients, which embrace these characteristics. We thought it might be interesting to share them with you in this issue of ***Observations.*** These principles are:

♦ ***<u>Focus on Out-of-Favor Undervalued Stocks</u>***. Successful investing requires identifying not only good companies, but also those selling at reasonable prices/valuations. *Bargain* prices (as opposed to *justifiably depressed* prices) are usually only available when a company is having temporary problems, and the investment herd is either 1) wrongly projecting those problems to be permanent, or 2) too impatient to wait for the turnaround. We spend considerable time and effort analyzing and evaluating a) whether the problems are indeed temporary, b) how likely the problems will be solved, and c) what the company might be worth if the problems

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Inside This Issue:

The Good (*continued from p.1)*

We suspect that many of these investment managers *overestimate* their ability to "get out before everybody else when the situation blows up." Despite the liquidity of many of these investments, their prices will decline drastically if sell orders overwhelm buy orders after the ever-shifting investment psychology changes once again to favor more undervalued investments, as it inevitably will.

In this type of a market with multiple personalities, those professional investment managers who are prudently sticking to their value discipline and managing investment risks for their clients, by refusing to chase grossly overvalued investments, are quickly chided by the press and media as being out-of-step, stubborn, overly cautious and a few other adjectives that are not fit to print. In this environment, maximization of returns seems to be the *supreme (and only)* goal for many people, with no consideration of investment risks and no value attributed to actions taken to responsibly manage such risks.

Here at ***PDV*** we do not believe it is in our clients' interests to participate in this mania of chasing these large "momentum" blue-chip stocks. Our clients understand that following the crowd is not a sensible method to achieve *sustainable* long-term investment success, even though it might temporarily produce "easy" short-term returns, at least until the investment mood changes again.

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We simply try to seek out undervalued out-of-favor investments one at a time. We like to go to neglected areas of the market where there are no crowds and expectations are low. (Please read the accompanying article describing ***PDV***'s stock-picking principles). Regardless of what the broad market is doing, we generally are able to find such investments, though we tend to find more of them when the market as a whole is at low levels.

In our opinion, the widespread belief currently that these large-cap blue-chip investments are safe, as reflected in their overvalued stock prices, actually makes them risky. While nobody knows when the current big-cap mania will come to an end, it is certain that a lot of damage will have already been done by the time it's clear the mania is over. When that happens, many of the "good" will become the "ugly".

The "Bad":

The "bad" refers to the performance of many small and mid-sized companies in what are commonly known as the small and mid-cap sectors. Historically, such companies as a group has generated higher investment returns over time than larger, more mature companies. This should not be surprising since the former groups entail more investment risk, but offer the potential of faster growth. The market properly rewards more risky, faster growing investments with greater *potential* returns.

And yet, because of the current mania surrounding large blue-chip companies, the small and mid-cap companies as a group has been left in the dust. While May 1997 saw a healthy resurgence by the stocks of the better companies within these sectors (thereby helping them achieve respectable year-to-date returns), the difference in the relative performance between the small and mid-cap companies and the large-cap companies hasn't been this great for the past few decades. It is primarily among these small and mid-cap companies with good long-term prospects that we continue to find attractively valued investments for our clients. As stock prices have a strong tendency to track underlying business fundamentals and reflect proper valuation multiples over the long run, we believe that *thoughtfully* selected investments among the "bad" will turn into the "good" over time.

The "Ugly": Finally, the "ugly" refers to the performance of a sub-group of companies, mostly in the small-cap sector, that experienced a mania of their own last year before they imploded. These were faddish stocks that had all the momentum for a period of time last year and were seen by many ***at the time*** as can't lose investments that were going to the moon. For a while, it certainly did look that way. However, these stocks had business fundamentals that were wholly inadequate to support their extraterrestrial valuations at the time.

After sucking in a lot of investors with their seemingly alluring concepts, they badly disappointed with their operating results. Their stock prices were subsequently decimated, with many of them seeing their stock prices fall anywhere between 50-90% from their 52-week highs in just a few short months. Even with time, we suspect that many of these losers will never revisit their former highs. In short, many of the "ugly" will likely stay ugly.

Principles (*continued from p.1*)

are corrected. The stock's current price should be substantially less than its potential long-term fair value before we would consider it attractive for purchase.

♦ ***Patience an Essential Ingredient***. Over short periods of time, stock price movements have a very tenuous connection to fundamental business values, and stock prices tend to change a lot more than the underlying business values. Over longer time periods, stock prices tend to closely track the underlying business values. *We try to make the stock price movements our clients' ally*. When prices are well below the underlying business value, we buy for our clients. Conversely, when prices greatly exceed such value, we sell. When we invest in a stock for our clients, generally (but not always) we target a 30-40% return over a ***two-year period***. One should not expect the return to be achieved in an even or stable way (e.g. it's possible the stock might lag for 21 months but make all the gains in the final 3 months), but we generally want to see the stock price at least 30-40% higher at the end of the two-year period. We can't predict exactly how long it will take for a potential turnaround to materialize, but from experience we find 2 years is a reasonable period to allow for a business turnaround. For those investments that work out, some won't take this long, while others will take longer.

♦ ***Successful Investing Involves Turning Human Psychology on Its Head***. Money and investing invoke the most powerful of human emotions, greed and fear. It is risk and uncertainty that make people uncomfortable and engender fear. However, it is important to realize risk cannot be completely eliminated, and investing inherently involves uncertainty. Stocks that people feel "certain" will produce investment gains are nothing more than those about which a consensus exists. Such stocks usually have high valuations that already discount a lot of good news. Any slight disappointment would produce losses. The art of investing is actually about ***managing*** (and not the impossible task of eliminating) risk and uncertainty. *Viewed in this light, we try to exercise* ***emotional discipline*** *to be greedy when others are fearful* **assuming the risk/reward situation is good**, *and conversely we are fearful when others are greedy. This gives us the opportunity to buy stocks cheaply* *and sell them dearly for our clients.* We like out-of-favor stocks unburdened by high valuations and expectations, where positive surprises are likely.

♦ ***Adequate (But Not Excessive) Diversification is Good***. It is not possible to have a portfolio with nothing but winners. Inevitably, there will be some losers and there's no sure way to tell up front which ones they will be. Our goal is to have sufficient diversification for our clients, so that the winners will outweigh the losers, and generate a reasonable return ***on the entire portfolio*** consistent with our clients' investment parameters. Avoid focusing too much on any single security within the portfolio, and evaluate investment progress based on the portfolio as a whole.

♦ ***Don't Expect to Catch the Bottom or the Top Because We Seldom Will***. We will buy a stock if we feel it is selling at a big enough discount to its long-term fair value so that it has a reasonable opportunity to generate a 30-40% return over a 2-year period. This is the idea of the "margin of safety" embraced by legendary investors like Ben Graham and Warren Buffett. Because we like to invest in out-of-favor stocks, many of them are likely to be experiencing some short-term operating issues that often can (and do) get worse before they get better. Since we don't have a crystal ball, we will not be able to catch the bottom in the stock price. Worsening consensus sentiment could cause the stock price to continue dropping, creating an even bigger discount to fair valuation. Such short-term price drops are generally no cause for concern if one maintains a long-term investment time horizon and the business fundamentals remain intact to justify a turnaround in the company's fortunes. Depending on the circumstances, it may be a good opportunity to buy more. If business prospects turn around as anticipated, then the stock price will follow once investment sentiment improves. We will sell when the stock becomes overvalued. The momentum of improving sentiment could (and often will) drive the stock price even higher after we sell, but we prefer to reinvest your capital in other out-of-favor investments with better risk/reward characteristics going forward.