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PDV *OBSERVATIONS*

The Demise of Value Stocks Has Been Greatly Exaggerated

Horace said, "Many shall be restored that now are fallen, and many shall fall that now are in honor." This statement captures well the reality that the economy and companies/businesses tend to go through cycles.

Investment history is replete with examples of former high-flying companies returning to earth, with other temporarily depressed companies regaining past glory and renewed investor favor. Despite investors' oft extrapolation of recent trends (good or bad) into the indefinite future, investment history seems to bear out that things tend to "regress around a mean" in the long run. Even the highest quality companies will inevitably confront an occasional stumble or problem period.

Horace's remark also aptly describes what happened to value stocks on the one hand, and the Internet and big-cap growth stocks on the other hand in the second quarter of 1999. ***Value stocks came back into favor***, as investors began to rotate out of Internet and big-cap growth stocks. As interest rates rose in response to inflation fears, valuations were relevant again, hurting the overvalued sectors of the market.

As we have observed on numerous occasions, consensus about investing trends is often strongest just before the trend reverses. Given the overwhelming doom and gloom infecting value stocks at the beginning of the second quarter (after an unusually extended period of lagging performance), it is perhaps not entirely surprising that the resurgence of value stocks caught most people flat-footed.

During the first quarter of 1999 when value stocks were almost universally shunned, most of the mutual fund inflows went into only ***four*** growth funds loaded up with big-cap growth and Internet stocks. This is quite remarkable, as there are thousands of equity funds. This paralleled the move by the investment public into a concentrated group of overvalued Internet and big-cap growth stocks.

Paradoxically, just as investors fled the value-oriented mutual funds in droves after their patience wore out in order to chase short-term performance, value stocks began to outperform growth and Internet stocks. Consequently, these redeeming mutual fund investors capitulated at precisely the bottom, not only missing the rebound in value stocks, but also investing in the formerly hot segments of the market just as they began to cool.

Human behavior doesn't change very much over time when it comes to investing. We saw the same thing happen with emerging markets in 1997-98 and junk bonds in 1998. These areas were tremendously popular just before they imploded. People abandoned these segments in droves after the bubble burst, swearing never to return. As the emerging and junk bond markets soared in the past months, many investors who sold after the implosion missed the rebound. Buy high, sell low is often the modus operandi of those who find illusory

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comfort in following the herd.

As we write this, there is a moderate resurgence of the Internet and big-cap growth stocks. This is likely caused by "anchoring" as investors buy the dips (more on this in the "Anchoring" article below). Psychologically, it's difficult for people to believe or accept a trend change, when the trend has been so good to them. Those who continue to embrace these still overvalued stocks have pointed to our being in a "new era," where valuations don't matter.

Well, it's certainly true that valuations haven't mattered much in the past few years as *excessive* or *uninformed* risk-taking has been amply rewarded, but it doesn't mean valuations won't ever matter again. There's no doubt that certain aspects of our economy have made some permanent advancements (e.g. pervasiveness of the Internet and technological innovations that enhance productivity). Ultimately, however, valuations do matter because stock prices, as indicia of ownership in real businesses, do have a rational connection to underlying business results and fundamentals in the long run.

On the subject of new eras, one of the greatest investors of all time said, "The 'new- era' doctrine - that 'good' stocks (or 'blue chips') were sound investments regardless of how high the price paid for them - was at bottom only a means of rationalizing under the title of 'investment' the well-nigh universal capitulation to the gambling fever."

You might be surprised that these profound and powerful words discrediting new eras came not from some contemporary hot-shot money manager or investment strategist, but from Benjamin Graham in 1934 when writing his seminal work Security Analysis. Yes, we have seen these rationalizations to justify the unjustifiable throughout investment history. Those words ring as true today as they did sixty-five years ago. The script and lingo are the same, just involving different investment characters and manias.

The events in the past quarter have shown that the demise of value stocks has been greatly exaggerated. Their incipient resurgence not only brings Horace's remark into focus, but is consistent with the overwhelming historical evidence of the alternating outperformance of value and growth stocks. Value stocks outperform over the long run, even if they don't do well all the time (nothing does). If the trend reversal in the second quarter continues, it will bode well for value stocks and value-driven investment strategies.

Anchoring: Don't Let It Weigh Down Your Portfolio

What's "anchoring" and why should you care? Anchoring is the psychological process by which someone uses a reference point to make decisions. Anchoring is pervasive throughout the investment process, and many of us will, consciously or subconsciously, use it from time to time.

Anchoring can be useful because by adopting reference points, it allows us to reach decisions more quickly and easily by taking mental shortcuts. Practiced correctly, anchoring is particularly helpful in the investment arena *as long as the reference points are chosen correctly* to make sense of vast amounts of financial information.

However, anchoring can also be very harmful to your financial health, if used inappropriately. Two examples will illustrate the point.

First, market corrections in the past few years have been unusually short. People have been conditioned by their recent experience to "buy the dips." One often hears advice such as: "Company A was selling at $150 per share three weeks ago and now it's at only $100 per share, so it must be attractively valued and 'cheap.' It's a buy." The flaw in this reasoning is that in the long run a company's future likely stock price has *nothing* to do with the level of its historical price. The correct reference point at any time is how the *current* price relates to the projected

business fundamentals going forward, and not the historical stock price.

Second, and along the same lines, one often comes across pundits proclaiming some stock to be attractively valued because it sells at a discount to the general market (a.k.a. relative valuation). This kind of thought process runs the risk of getting people into trouble if the valuation of the general market (the reference point in this case) is absurdly overvalued. A stock that is selling at a discount to an overvalued reference point does not per se make the stock undervalued or "cheap." Depending on the size of the discount it may still be an overvalued stock, if only less absurdly overvalued than the general market.

As is apparent from the illustrations above, it's critical to use the anchoring process appropriately, or it will actually become hazardous to your financial health.

There's a Price for Everything

As we have remarked in previous issues of ***Observations***, successful investing to build long-term wealth requires managing risks as well as seeking rewards. Attractive investments tend to possess certain financial characteristics, while poor investments are associated with an entirely different set of attributes.

Since nobody can predict the future, successful investing involves ferreting out those investments with as many desirable characteristics as possible, while minimizing to the extent possible unfavorable ones. This tilts the odds of success in your favor. On the other hand, you want to avoid those investments with characteristics that tilt the odds of success against you. While this may seem obvious, you might be surprised how many people unknowingly tilt the odds against themselves by following the herd and overpaying for stocks.

Let's illustrate how you might analyze the odds of success for what is currently one of the most popular big-cap growth stocks, which we'll call "Company X." I don't want to reveal its identity because some readers may own this stock in accounts not currently managed by PDV, and what I'm going to say about Company X is bearish.

Many factors determine whether the odds favor or disfavor an investment working out over the long run. Four of the most important are: 1) current level of earnings, 2) expected growth rate for these earnings, 3) prevailing level of market interest rates, and 4) the price you pay for the investment.

A company is more valuable if it generates high earnings that grow quickly over time amidst a low interest rate environment. But, you will only likely achieve good long-term results if you buy a valuable company's stock at a reasonable price and resist over-paying.

There are many different ways to determine what is a reasonable price. One of the most popular is by analyzing the price-earnings ratio ("p/e ratio").

Company X scores high on factors (1) and (2), and current interest rates are still considered quite low (despite the recent increase). Company X is therefore a very valuable company. However, this fact is widely known and its popularity has pushed the price of its stock to such astronomical levels that the odds of this investment doing well for let's say the next 10 years are not favorable. Let's examine its p/e ratio to see why.

Company X is currently selling at a p/e ratio of about 75. Its earnings are artificially and grossly inflated by the fact that its compensation expenses are kept off its income statement through the issuance of very generous stock options. In effect, because the earnings or "e" of Company X are artificially inflated, the true p/e ratio of Company X is actually even higher than 75.

When you pay 75 times Company X's earnings per share for its stock, your initial return on your purchase is 1.33%. (You arrive at this number by taking the inverse of the p/e ratio, which is known as the "earnings yield.")

Since you can currently get around 6% from a long-term Treasury bond free of default risk, it would be absurd for anyone to prefer Company X at current prices unless there is an opportunity for the initial 1.33% earnings yield to grow over time. And since investing in the stock of even the best company will entail more risk than a Treasury bond, one should not prefer Company X's stock unless it actually offered a potential return *in excess of* the 6% yield currently offered by the Treasury bond.

Based on the current interest rate environment, Company X's stock must have the potential to produce an earnings yield in excess of 6% in the not-too-distant future to become an attractive investment compared to a long-term Treasury bond. This compensates for the fact that Company X will generate lower returns/yields in the initial years.

Wall Street currently projects Company X to grow its earnings annually in the range of 25% compounded, but this seems entirely too optimistic. Aside from some serious problems that are currently ignored by Wall Street, but which will likely slow the company's growth, Company X's enormous size makes it more difficult to grow as rapidly as in the past. Historically, there are very few companies that can grow more than 15% a year compounded on a sustained basis.

Let's give Company X the benefit of the doubt and assume it'll continue to grow its earnings at an average 20% annual compounded rate. Company X would double its earnings roughly every 3 1/2 years at that growth rate. That level of earnings on your purchase price would produce an earnings yield of about 2.7% after roughly 3.5 years and 5.4% after 7 years (still *lower* at that point than the yield currently available from long-term Treasury bonds). While this return would be tax free until you sell Company X's stock (since it pays no dividends), the 6% yield of the Treasury bond is also partially tax-exempt. Since interest rates are currently at the lower end of the recent historical spectrum, any increase in interest rates in the interim would of course make the hurdle rate even higher for Company X's stock.

As you can see, these are not good odds. Even giving Company X the benefit of the doubt by ignoring its inflated earnings and assuming a spectacular (and unlikely) compounded rate of growth, it would still take a long time before Company X's earnings would reach a level that will give you a competitive return on your investment compared to long-term Treasury bonds with no default risk.

While short-term momentum and the current casino-like herd mentality would likely ignore such fundamentals and could push Company X's stock price even higher, in the long run these bad odds will likely hurt this stock and those buying at today's elevated prices.

Despite their sub-par performance in the past quarter, big-cap growth stocks still generally sell at astronomical p/e ratios. Apparently, many people are willing to accept these poor odds. Prudence suggests otherwise.

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