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PDV *OBSERVATIONS*

Value Investing Wins Over Time:
But It Is Not for Everyone

Over the past several months, there are incipient signs of value stocks and investing returning into favor. It has been a long time coming. When the turnaround is complete, we expect the rebound to be very powerful, given the vast majority of value stocks have been in a prolonged bear market. Since the speculative and overvalued segments of the market imploded, "r-i-s-k" has once again become a dirty four-letter word for many, especially those trading/ speculating on margin.

With this year's unprecedented market volatility and the swift evaporation of $billions of market value for many over-hyped popular stocks in the technology, biotech and telecommunications areas, it is not surprising that value investing is starting its comeback. Value-driven investment strategies usually shine during periods when investors care about risk management (often after previously ignored risks have materialized and hurt them).

Despite the proven long-term superior efficacy of value investing, it requires a high level of independent thought, patience and emotional fortitude which most people by nature find difficult to practice or accept.

Who are the people likely to find it difficult to remain committed to value investing and therefore abandon it before the strategy comes to fruition? Value investing is likely to frustrate and disappoint THOSE WHO:

- need their investment decisions *immediately* validated by the market with positive short-term price movements, or feel the need to follow the consensus and chase what's hot;
- would settle for immediate gratification, rather than ***greater*** delayed gratification;
- think of the stock market as a casino, where stocks are the "chips", rather than ownership interests in real businesses whose values should be analyzed and compared to their stock prices to determine the attractiveness of the investments;
- have a short time horizon, or who have a long horizon but lack patience and/or emotional fortitude;
- have an irresistible urge to "hop on a train already dangerously overloaded with a lot of other people before it leaves the station," without feeling a need to investigate how damaged or strained that train might be;
- feel envious of other people seemingly making easy money, without considering how risky their behavior might be or how sustainable those easy gains might be;
- care more about avoiding lost opportunities than protecting against ***permanent*** capital loss, and for whom the joy from making money outweighs the pain from ***permanently*** losing money;
- think the market always fairly and efficiently

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prices/values stocks all the time because people are rational when approaching investment decisions, so that the business value of the underlying business (what you get) is always the same as its stock price (what you pay);

- think analyzing business dynamics, financial statements etc. and security analysis add little or no value to investment results, so it's irrelevant what price is paid for a stock or whether much, if anything, is known about the underlying business;
- consciously or subconsciously treat investing as a form of gambling;
- use value investing to win sprints, ***when it's designed for marathons;***
- think near-term results are more important than long-term results, because the thrill of the sprint is more meaningful than crossing the finish line and achieving one's financial goals according to a prescribed schedule;
- like to use their short-term account progress as fodder for cocktail conversation;
- treat their investment progress as a horse race against neighbors, friends and relatives who are claiming outsized returns (often without substantiation), rather than a wealth accumulation process with risk/reward characteristics and a time horizon that are ***unique*** to them and designed to advance their particular financial goals, *rather than somebody else's*; and/or
- feel the need for social acceptance by their friends, neighbors and relatives, and therefore follow their lead in investing in what's most popular at the time, rather than what's most undervalued with attractive long-term appreciation potential.

As you can see, value investing is not for everyone. But for those who have the ***patience, confidence of independent thought*** and ***emotional fortitude*** to commit to it on a long-term basis through different market cycles, it will be very rewarding indeed.

Stock Options for Tech Companies: The Downward Spiral

All U.S. companies are required by law to report their business results according to generally accepted accounting principles ("GAAP reporting"). Compared to accounting/reporting standards governing foreign companies in other parts of the world, GAAP reporting is generally considered superior.

However, financial statements prepared according to GAAP reporting are by no means a perfectly accurate depiction of a company's financial and operating situation at that particular point. Given inherent limitations of GAAP reporting, the competent security analyst must make certain adjustments to financial statements to arrive at a more accurate picture of a company's ***true*** financial and operating condition.

As GAAP reporting allows considerable flexibility for reporting data, companies have options to present their earnings in several different ways. Legally, companies are often able to *overstate* their earnings, thereby presenting a rosier financial picture than is actually the case.

In this article, we want to point out one particular limitation/weakness of GAAP reporting that allows companies, especially tech companies, to inflate earnings. A diligent and prudent investor should not invest in such companies without being at least aware of how this accounting quirk can misleadingly distort the true economic earning power of such companies.

This area of significant concern relates to the excessive use of stock options to compensate employees. There are many legitimate reasons why companies like to use stock options to reward employees. Unfortunately, most stock option arrangements are structured poorly and do not really advance the otherwise laudatory goals announced by corporate management of aligning management's interests with those of shareholders and properly motivating good performance. Too few stock option programs are established properly, with too many of them offering substantial potential upside to those receiving the options, with no downside for poor performance.

Stock option programs are not inherently good or bad; it depends on how they are structured. A few stock option programs, when set up properly, are value-enhancing tools. What **is** severely lacking, however, is how GAAP reporting inadequately accounts for the cost of stock options on financial statements. But this quirk is actually one of the reasons why companies like to grant stock options as a substitute form of compensation.

Under GAAP reporting, costs associated with stock option grants do not impact the income statement even though it's absolutely clear stock options have a cost to the granting company every bit as real as cash compensation. While evaluating the cost of options is part art, part science, and it cannot be determined with the same precision as the cost of cash compensation, reasonable estimates are possible.

The accounting profession has been fighting with corporate America for a long time to require that reasonable estimates for the cost of stock options be made and included on the income statement, but ultimately lost out to the powerful business lobbies. At this point, most U.S. companies simply choose the much less onerous option of including the estimated cost in an obscure part of the financial statement footnotes that few people read.

In view of the foregoing backdrop, it is not difficult to see how **overstated** earnings are for those companies that use stock options as a big part of their compensation system. Since compensation expenses are usually a huge portion of the total expenses, the ability to exclude that much compensation costs from the income statement makes the bottom line look so much better than the reality.

The inflated earnings picture benefits the tech companies probably more than the companies in any other industry. Why? Because tech companies tend to compensate their employees mostly through stock options. While here at PDV we agree that tech companies have some of the most dynamic growth prospects going forward, their stock prices have in many cases already more than reflected this generally recognized fact. One does have to wonder how much of the tech sector's strong profit outlook is attributable to accounting fiction?

We believe that many tech stocks run a substantial risk of getting caught in a downward spiral, when this accounting quirk no longer benefits them. With many tech stocks still grossly overvalued despite their considerable drop in the past few months, any disappointment in their ability to sustain high earnings growth will further hurt their prices.

So how exactly might this downward spiral develop? When tech stocks were shooting up, employees preferred stock options over cash compensation because options allowed them the opportunity to make a lot more much faster as long as the stock price continued climbing. This was pretty much what happened during the fourth quarter 1999 and first quarter 2000, as individuals and professionals alike chased the momentum of the tech sector.

Then the roof caved in on the sector and many of those options that were recently granted became substantially "under water." Unless the stock prices of these tech companies rebound a great deal, these options have very little current value. Suddenly options don't look so attractive anymore, as "a bird in hand" looks better than "the two in the bush." Anecdotally, employees have begun leaning towards good old-fashioned cash compensation. Well, there's only a slight problem with that. Cash compensation must be "passed through" the income statement, reducing reported earnings and antagonizing Wall Street.

If tech companies continue to shift from primarily a stock-option compensation system towards a cash compensation system, the increase in the expenses that need to be deducted on the income statement will decimate reported earnings of tech companies. With such high earnings expectations built into tech stocks currently, one can expect considerable downward pressure on such stocks once the increased cash compensation is reflected on the income statement.

In the past, many tech companies would have tried to solve the problem by "repricing" their stock options at the then prevailing lower price. This placated employees because only a small price rebound would be needed to create value with respect to the repriced options (though for shareholders repricing was usually a lousy arrangement). Unfortunately for the corporate finance "spin-meisters," recent accounting improvements have mandated that any cost associated with option repricing must be passed through the income statement (whereas prior to this, there was no adverse impact on the income statement or reported earnings). Needless to say, option repricing has become a lot more unpopular with companies, which try to protect their reported earnings from dropping.

Management, especially for tech companies, has begun to find itself between "a rock and a hard place." With recently granted stock options severely under water and the repricing avenue largely closed out, tech companies are increasingly faced with the unpalatable choice of paying a lot more cash compensation to their employees (which would really hurt their reported earnings), or risking the loss of personnel in this labor-constrained market.

To compete, our best guess is that tech companies would have to pay up in cash, which would hurt their reported earnings and stock price. With a further declining stock price, stock options become even less desirable, increasing the emphasis towards higher cash compensation, which further pressures reported earnings. Thus the downward cycle runs full circle.

Many tech stocks are still priced for perfection. Anecdotally, tech stocks' popularity among the investment masses is still at an unprecedented high. If you own tech stocks, have you considered the above scenario? It's about time.