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PDV *Observations*

A Quarterly Newsletter for PDV Clients and Friends

Balance is Key

By Che H. Lee
President

Our perception is often subconsciously shaped by our mood. If we are pessimistic, we tend to see darkness everywhere; we find brightness when we are optimistic. We also love labels as mental short-cuts, as in "I'm bullish, you're bearish." In reality, our thinking or positions are much more nuanced. Once we adopt these labels, we tend to look for evidence to confirm our prevailing mood or viewpoint (psychologists term this "confirmation bias"). If we think the world is coming to an end, we see all news as bad (or ignore the good news). And if we are optimistic, we may similarly focus on the good and ignore the bad. The truth is that there are always some good and some bad news — reality is not a binary bright/dark, but shades of grey. Having too extreme a position or too certain an opinion about what will happen to the market or economy and acting on it emotionally is a good way to destroy your finances.

After the ***temporary*** but swift market drop and heightened volatility in the past two months, and with the pain from the 2008-09 financial meltdown still fresh in our minds, it is natural to be nervous and pessimistic. Our mindset within this context may be predisposed to negative news, which the media is only too happy to oblige.

To achieve investment success, we have always found it useful to maintain a balanced perspective and avoid emotional behavior or reactions. It is also important to admit what we don't or cannot know, and to avoid extreme positions in reaction to unpredictable future events. To abandon a well-thought out long-term investment plan or to get out of the market *completely* because you are certain that the economy and the markets are going to implode will most likely destroy your finances over time. Don't give in to alternating bouts of fear and greed. Even IF you are correct, when do you get back in? If you wait until the "coast is clear," prices will have moved up well before that time. Besides, the coast is never completely clear, even if it may seem like that from time to time. The current market may be much lower than it was 2 months ago, but it is still much higher than it was in March 2009, which was the market bottom following the 2008-09 financial meltdown. Of course, few, if any, predicted the spectacular market turnaround from March 2009 to April 2010.

Does it feel to you like our country is in a foul mood right now, infected with a widespread sense of malaise? It does to me. Media content is often a ***reflection*** of our collective mood and psyche at the time of dissemination. Perhaps it should be unsurprising that currently we are confronted by so much negative news. Is there really no good news out there? Yes, there is.

Inside This Issue:

With global economies becoming increasingly interconnected, it is important to look at international news as well. Here's a sample list:

- Recent demand for the European Central Bank (ECB)'s three-month loans was well below expectations; this shows the European banking system is not nearly as stressed as commonly feared and European banks continue to lend to each other on an overnight basis rather than rely on the ECB.
- The Chicago Purchasing Managers Index and Institute for Supply Management's Index both showed continued growth in manufacturing in June.
- US corporations have greatly de-leveraged and collectively possess the highest levels of cash/liquidity as a percentage of their tangible assets than at any time since World War II; this massive liquidity will help them grow, expand, pay dividends, buy back stock and make acquisitions.
- As mortgage rates continue to fall to all-time lows, mortgage applications rose nearly 9% last week; refinancings help consumers save money.
- Oil/gasoline prices have dropped over the past months, putting more money in consumers' pockets.
- Spain, widely feared as one of the countries that could default on its debt down the road, was able to raise $4.3 billion in an oversubscribed bond auction; spreads on long-term Spanish bonds are contracting, indicating funding fears are receding.
- After plummeting for weeks, the Euro has finally stabilized against the US dollar; a stabilizing Euro helps the reported profits of US companies with European operations as profits earned in Euros are translated back to US dollars.
- The recent Japan Tankan corporate confidence survey came in stronger than expected.
- Manufacturing output continued to expand in China, Japan, South Korea, India, Australia and Taiwan.
- May US personal income, spending and savings all rose.
- Unemployment rates dropped in May for roughly two-thirds of the largest US metropolitan areas.
- German unemployment continued to fall in June for a 12th consecutive month and German exports are almost back to pre-crisis levels; this is important because Germany, as the largest economy in Europe, is key to reviving growth in the Eurozone.
- Ford, GM, Chrysler and Daimler US unit sales in June were up 13.3%, 10.7%, 35% and 20.5%, respectively, over last year.
- Earnings of companies in the S&P 500 grew 55% in 1st quarter of 2010 from a year earlier, and is estimated to grow well over 20% year-over-year in the second quarter.

Confirmation bias is dangerous to your financial health. I recommend a balanced approach when evaluating economic and market developments. There is always some good news and some bad news — reality is shades of grey. Recognizing this will help you avoid emotional decisions based on overconfidence.

Economic Moats

By Louisa Ho
Senior Portfolio Analyst

Warren Buffett loves businesses with economic moats. Such businesses possess significant competitive advantages over rivals. Economic moats help businesses ward off competition, and generate superior sales and profitability over competitors.

However, competitive advantages should not be viewed as indicative of a genuine economic moat unless they are likely to be sustained over time. For instance, having the ability and resources to introduce products with superior technology is a competitive advantage, but technology is constantly advancing. What may be a cutting edge technology today may become obsolete several months later. Competitors are always coming up with better products by adding or improving features. Since it is difficult to constantly stay one step ahead of competitors in the technology industry, the excess profits generated through this sort of short-lived competitive advantage, or "narrow economic moat," are unlikely to be sustainable.

In contrast, competitive advantages that are large and sustainable, or "wide economic moats," can more effectively give a company an edge over its competitors over time. Below is a discussion of some factors that can create wide economic moats.

Economies of scale

Economies of scale confer cost advantages on a company as it expands operations and scales its infrastructure. Larger companies are often able to offer products at lower prices than smaller competitors because their cost of goods is lower. Walmart is the prime example of a company with economies of scale. Because of its mammoth size and sales, Walmart has tremendous bargaining power with its suppliers and can spread its costs across a wide global store base. Using this advantage, Walmart can drive down prices, undercut competitors, gain market share and still make a respectable profit.

Home Depot, Costco and Best Buy are examples of other dominant companies that have significant bargaining power with their suppliers and the ability to offer products at prices that often undercut their smaller competitors.

High switching cost

High switching cost refers to the inconvenience, time and/or money when switching from one product or service to another. The higher the switching cost, the less likely the customer would abandon a product in favor of a comparable product offered by a different firm. High switching cost essentially "locks in" customers, which helps a company maintain or raise prices, and earn good profits over a long period of time. The ability to lock in customers also creates a barrier to entry to other competitors trying to poach customers.

Adobe is an example of a firm whose design software involves high switching cost. With its Photoshop software being the industry standard for graphic design and photo editing, most designers are likely to be trained on this software. The steep learning curve associated with other competing programs deters migration to other programs. This customer lock-in effect makes it very difficult for a competing product, even a superior one, to take meaningful market share.

Medical device companies that produce instruments requiring a lot of training time are another example of companies that benefit from high switching costs.

Intangible assets

Examples of intangible assets include brand names, patents, and government approvals etc. They can help differentiate products, deter competitors from entering the market and enable a company to charge higher prices for its products.

Strong brands like Coca Cola, Nike and Kleenex are well recognized by consumers worldwide. Even though these brand-name products might not be that much different from their generic counterparts, the high brand awareness often improves consumers' willingness to buy, boosting sales and protecting market share.

Patents protect products from competition, at least for a period of time. Drug companies are an example of companies benefiting from patent protection. A blockbuster new drug can generate tremendous profits before the generic version is allowed to be introduced.

Lastly, government licenses or approvals act as barriers to entry, because the required process to acquire these licenses or approvals is often lengthy, complex and costly.

Network Effect

The network effect refers to the increasing value/utility of a particular product for both new and existing users, as more people use that product or as other products are introduced to complement the original product. The greater the network effect, the more likely a company will dominate within its field.

For example, Adobe's Photoshop is the most widely used software for graphic design and photo editing, just as its Acrobat Reader is the most popular for reading PDF documents. The more people use Photoshop and Acrobat Reader, the more likely these products become the industry standard, and the more likely users of these products would adopt other complementary Adobe products.

Credit card companies also benefit from the network effect. As more users carry a particular card, the more likely merchants will accept it. And as more merchants accept the card, the more likely consumers will want to use the card.

Businesses with sustainable economic moats make potentially attractive investments. However, the existence of such a moat does not automatically make the company's stock a buy. Often, the market overvalues the moat and has already driven the stock price above justifiable levels. At other times, a company with a moat has undesirable attributes that can negate the value of the moat. It is therefore important to view the existence of an economic moat as just one of many factors to evaluate when searching for promising investments.