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# PDV *OBSERVATIONS*

**A personal note**: As we conclude the first year of publishing ***Observations*** with this issue, we would like to extend our heart-felt thanks and appreciation to all our clients and friends who have complimented ***Observations*** in the past year and taken time to give us constructive and most welcomed suggestions as to how we can make it even better. We have seen **PDV *Financial Management*** grow in a most gratifying way in the past year thanks to our clients and friends. We would like to take this opportunity to thank them for their trust and support. Again, if you know someone who would be interested in receiving complimentary copies of ***Observations***, please let us know. Happy New Year!

## A Few Thoughts on Risk

Many people are familiar with the joke about investors' expectations regarding investment returns. When asked what an investor expects from his investments, he responds "I don't want any risk, but I want to get rich overnight" or words to that effect. Now, back to reality...

The truth of the matter is there is no such thing as a riskless investment. But you might ask "what about government-insured bank certificates of deposit and treasury bills?" The answer depends on the appropriate definition of investment risk, which is the subject of this article.

Arriving at an all-encompassing definition of risk can be elusive. The Securities Exchange Commission is currently struggling with little success to promulgate a set of guidelines that will more clearly define the risks associated with different types of mutual funds.

While people will always disagree on an appropriate definition of investment risk, let us suggest several ways to look at it. And you can relax because we will spare you from discussing concepts like beta coefficients, alphas, R-squared's, Sharpe Ratios and standard deviations.

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The first suggestion we have is to take inflation into account when analyzing risk (something which alot of investors fail to do). An investor investing in government-insured CD's might have a false sense of security because she knows she will get back at least her principal. But she is actually assuming the risk that the inflation rate might exceed her fixed return on the CD, so that she may actually suffer a ***loss in purchasing power***. Ultimately, money is valuable because of its purchasing power.

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Another important concept to keep in mind when evaluating risk is the inseparable relationship between time and investment risk. An investor can buy the greatest stock in the world, but if (using an extreme example) he has a one-day time horizon, that investment would be very risky. Afterall, who can be sure which direction the price of the stock will take tomorrow, even if one can be reasonably sure that the stock will appreciate over let's say a 2-year time horizon.

To develop the necessary emotional discipline and ability to distinguish between risk of permanent loss of capital and unjustified temporary quotational loss requires a greater time commitment to understanding and monitoring business fundamentals underlying investments than many people are willing to make.

Yet another issue to focus on is the critical distinction between permanent and ***quotational or paper*** loss of capital. Permanent loss of capital occurs when you decide to convert a quotational or paper loss into a permanent capital loss by selling a stock because 1) you need the cash proceeds for emergency or other living expenses, 2) emotionally you are uncomfortable seeing your investment experience quotational losses (even though the current stock price undervalues the future prospects of the company, or 3) you decide that the prospects of the stock have permanently deteriorated, and it is advisable to sell to cut further permanent losses.

The foregoing sheds light on what actions investors can take to minimize risk. First, history suggests that investors should allocate at least a portion of their assets to growth-oriented investments because of inflation.

Second, investors must have a reasonably long investment time horizon as well as adequate reserves for emergencies to ride out any downward interim quotational movements that undervalue future business prospects.

Also, investors should be emotionally prepared to resist succumbing to selling undervalued securities with paper losses that are temporarily out of favor. On the other hand, investments whose price declines accurately reflect a permanent deterioration in business prospects should be sold quickly.

To develop the necessary emotional discipline and ability to distinguish between risk of permanent loss of capital and unjustified temporary quotational loss requires a greater time commitment to understanding and monitoring business fundamentals underlying investments than many people are willing to make. Unfortunately, there is no way around the fact that it is difficult to treat investing as a part-time occupation.

# *The Allure of Short-Term Bond Funds*

When investors want investments offering stability in principal value, they generally think about short-term certificates of deposit or money market funds. Those who want higher yields and/or capital appreciation and are willing to take more risk tend to focus on mutual funds that invest in bonds with intermediate to long-term maturities. The result is that short-term bond funds often become the Rodney Dangerfields of the bond fund universe - they just can't get any respect.

In actuality, short-term bond funds may at times be a preferable investment to money market funds as a cash substitute. While the principal value of short-term bond funds will fluctuate more than money market funds, their principal values are still quite

stable because short-term bond funds tend to hold bonds with maturities varying between one to three years. Therefore, they tend to have fairly muted reactions to interest rate changes. On the positive side, short-term bond funds often yield quite a bit more than money market funds, and the incremental yield often outweighs the marginal extra risk involved, especially in a stable interest rate environment.

Depending on the interest rate outlook, PDV will at times try to increase client investment returns by investing their cash reserves in short-term bond funds rather than money market funds.

A couple words of caution. First, many investors use the check-writing privileges associated with money market fund accounts. Essentially, shares in the money market fund are automatically sold to pay checks that are written against the account. This feature is not available with respect to short-term bond funds.

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Second, avoid being misled by fund names. Many so called short-term bond funds in fact hold securities that present considerable interest-rate risk. For example, those holding exotic securities like derivatives could decline in an unexpectedly severe fashion in response to interest rate changes. As with all mutual funds, you need to have a good understanding of the characteristics and nature of the actual underlying securities held by the bond funds.

# THE SIGNIFICANCE OF THE MARKET DIVIDEND YIELD

**Where is the market going from here?** This is one of the most common questions that investors ask. An entire industry of market experts and other prognosticators stand ready to offer their informed (and sometimes uninformed) opinions for a fee. Some have attained instant fame (and sometimes fortune) by being "right" about the market.

In their rush to embrace these market "guru's", Wall Street and investors often fail to examine the longer-term records of these experts. The truth of the matter is that many of them have made as many wrong calls as right calls.

Some of the greatest investors of all times, like Warren Buffett, John Templeton and Peter Lynch, freely admit that they do not try to time the market, because they are convinced that nobody can do it ***consistently*** well. Instead, they take a long-term perspective, focusing on the prospects of individual securities, rather than what the markets might do.

If one examines the history of the stock market, one finds that bear markets (ie. periods when markets drop precipitously) are very much a part of the normal progression of market cycles (even though they seem anything but normal while one is going through them!). While the timing of bear markets is very uncertain, their occurrence from time to time is as certain as the pattern of night following day.

We, at PDV, also believe that nobody can consistently time market movements. However, bear markets do tend to develop when certain factors are prevalent. While these factors are too numerous to discuss here, we would like to discuss one of the most common financial ratios that people use to

gauge the level of the market, namely its dividend yield.

When people refer to the market, they are really referring to a group of companies whose stocks are included in one of the popular stock market indexes, like the S&P 500 or the Dow Jones Industrial Average. Please refer to the 1995 Fall issue of *Observations* for a discussion of some of the more popular indexes and what they mean. We will use the S&P 500 Index here for illustration.

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The dividend yield of the S&P 500 is essentially the aggregate dividends paid out by all the companies included in the S&P 500 Index divided by the companies' aggregate market price. One other technical term that you should be familiar with is the "payout ratio". This is the percentage of a company's earnings that is paid out as dividends. For example, a company earning $10 per share and paying out $5 per share in dividends would have a payout ratio of 50%.

When examining the history of stock market returns from the period of 1926 to the present, one finds that the market dividend yield has averaged around 4.7%. Currently, the market dividend yield is closer to 2.3%.

The stock market traditionally is considered overvalued when its dividend yield falls substantially below its long-term historical average, as is the case today. One countervailing factor, however, is that payout ratios of companies representing the S&P 500 Index are relatively low by historical standards. So, the market dividend yield would be higher if companies were to follow more traditional payout policies.

As mentioned in previous issues of *Observations*, PDV allocates client assets among three broad asset classes of stocks, bonds and cash, before selecting mutual funds or individual securities to implement the asset allocation strategy. Obviously, the most important factors determining the asset allocation mix are the client's particular financial situation, investment time horizon and risk tolerance level. But the relative attractiveness of the stock, bond and cash markets also affect the way client assets are allocated.

While we cannot predict with certainty what the markets might do next week, much less next year, we will make informed judgments as to the relative valuations of the stock and bond markets, and implement asset allocation changes on behalf of our clients based on such judgments. In the long run, these judgments are likely to be more productive than attempts to catch market swings, since excessive valuations in any market will tend to correct over time to ***normalized*** levels.

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