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PDV *OBSERVATIONS*

Value Stock Mutual Funds: What's the Prognosis?

Over the past few years, value-oriented stock mutual funds (a.k.a. value funds) have greatly underperformed growth-oriented funds (a.k.a. growth funds). Given the recent relative underperformance of value funds, here at PDV we believe this is a particularly opportune time to invest in them. We explain why in this article.

What Are Value Stock Mutual Funds?

Value funds are those that use a value-oriented investment approach to buy companies whose stock prices are selling at a discount to the business fundamentals and intrinsic worth of the companies. This type of fund recognizes that long-term investment success depends on, among other things, viewing a stock purchase as buying an ownership interest in an operating business.

Both the quality of the business and the ***price*** at which you buy your ownership interest will determine your investment results over the long term (please see the article "*Successful Investing*" on page 3 for further discussion of this important issue). Ideally, these funds would like to buy the highest quality businesses at the lowest price to maximize investment returns. ***Realistically,*** good value-oriented investment managers (a.k.a. value managers) have to determine the optimal trade-off point between price and quality, as higher quality businesses generally do (and should) command higher prices/valuation.

What Are Growth Stock Mutual Funds?

Growth funds tend to invest in businesses that are experiencing fast growth in earnings, cash flow and/or sales. Many growth stock fund managers (a.k.a. growth managers) are quite insensitive to price considerations, and will pay little attention to how much they are paying for the shares of a company as long as it is growing quickly.

What Has Been the Relative Performance History of Value and Growth Stocks?

Extensive data on the performance of financial markets and securities since 1926 have overwhelmingly shown value stocks to have outperformed growth stocks over time.

For any long-time observers of the financial markets, this should not come as a surprise. Value stocks usually are experiencing some short-term issues with their businesses, temporarily depressing their stock prices. They are generally "low-expectation" stocks, where a lot of bad news is already built into their price. Continued bad news will tend to have a relatively muted effect on the stock price of value stocks, while positive surprises would have a disproportionately beneficial effect. The risk/reward characteristics therefore are generally superior for value stocks, as long as 1) you have patience, and 2) you correctly identify which companies will resolve their short-term business issues and prosper again.

On the other hand, growth stocks are the darlings of Wall Street, and their momentum attracts a lot of followers. As a consensus forms around the attractiveness of a growth stock, it creates a self-fulfilling prophesy in the short term and gives the illusory impression of safety and comfort (i.e. the business is growing well, everybody loves this company, so it must be a great can't-lose investment, etc.).

Of course, all things being equal, you should try to own the fastest growing companies ***as long as***

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their growth can be sustained over time and they are selling at a favorable price. Unfortunately, the enthusiasm for growth stocks often stretches to an extreme so that no price is too high to pay for this growth.

These "high-expectation" growth stocks have a lot of good news built into their price. In reality, widely optimistic projections of rapid growth in most cases will turn out to be unsustainable over time. As a company grows in size, it's more difficult for its growth to continue at the same rate. When disappointment hits and the investment herd all head for the exit at the same time, the stock price often gets decimated from what was likely to be an excessively high level because of the previously strong demand for the company's shares.

Do Growth Stocks Ever Beat Value Stocks?

Yes, in fact the most recent outperformance by growth stocks occurred from 1994 to the present. Historically, value and growth stocks take turns outperforming each other over multi-year periods. But since 1926, value stocks have outperformed growth stocks by a ***wide margin***.

Is the Recent Underperformance of Value Stocks Permanent?

No, but it might feel that way to the people who've owned value stocks for the past few years. For long-term investors in value funds, their recent underperformance may in fact be seen as a harbinger of likely outperformance in the coming years. Here's why.

As discussed previously, value stocks have outperformed growth stocks over time by a substantial margin. Skilled value managers buy stocks at a discount to the companies' intrinsic business values. These discounts are usually created by short-term operating issues clouding the immediate prospects of such companies and the investment herd's over-pessimistic reaction to them. As the companies resolve their short-term business issues, the stocks will likely find favor again with investors, in many cases eliminating the discount completely. Since human nature often reacts to extremes when it comes to the financial markets, investors may even push previously undervalued stocks to a point of overvaluation, as excessive pessimism (fear) is overcome by excessive optimism (greed). Here at PDV Financial, we've seen these situations recur frequently.

When a value fund is underperforming, it's

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because of one of two reasons: 1) the investment manager is incompetent, or 2) the investment manager selected a portfolio of undervalued stocks with attractive long-term characteristics, but which remain out of favor with Wall Street in the short term. As sentiment worsens, undervalued stocks can get more undervalued before they eventually recover.

As long as you have a competent value manager, then with patience you can expect that recent underperformance is often a sign indicating likely future outperformance, as many of the undervalued securities close their valuation discounts over time. Remember that even the best investment managers won't do well every year (as we alluded to in the Fall 1998 issue of ***Observations***). So recent underperformance does not necessarily mean future underperformance, and may in fact indicate the contrary with respect to portfolios managed by skilled value managers.

A Final Cautionary Note: Will the True Value Investment Managers Please Stand Up.

Deciding who are the truly competent value managers is very difficult. ***In reality, truly outstanding value managers are few and far between, because it takes so much emotional discipline to execute a value-oriented strategy successfully over time.*** Many managers who call themselves value-oriented are anything but. With growth stocks much more in vogue these few years, many investment professionals have quietly abandoned their value discipline to chase growth stocks. The short-term performance "rat race" among institutional investment managers has caused this.

As many growth stocks have seen their valuations stretched to ridiculous extremes in the past

few years, buying into some of these so-called value funds will produce a nasty surprise. Instead of getting a portfolio of undervalued securities with attractive appreciation potential over the long term, you could find yourself owning a basket of overvalued securities with good recent performance, but which are destined to fall substantially as prices inevitably drop over time to more accurately reflect lagging underlying business fundamentals and values.

In conclusion, as long as you can identify value funds run by competent investment professionals, their recent underperformance offers a good opportunity to position your portfolio for likely future outperformance.

Successful Investing: Managing Odds Using Knowledge, Courage and Emotional Discipline

Investing at its core is about predicting the future, and therefore necessarily involves risk. Nobody, including successful investment managers, can bat 100% when predicting the future. The next best thing good investment managers can do is to identify investments possessing characteristics that tilt the odds for success in their clients' favor.

Over the long run, the stock price and the business value of a company generally converge and the two tend to track each other very closely.

Of course, any one investment might not work out despite having the odds of success in its favor, just as another investment might ultimately work out despite having the odds against it. However, by applying an investment ***process*** in a disciplined fashion that tilts the odds in your favor across a *diversified* portfolio of investments, you will likely produce more winners than losers and achieve satisfactory overall results.

Tilting the odds in your favor when investing is not the same as rolling the dice in Las Vegas. Successful investments tend to share certain attractive financial characteristics (e.g. genuine stock repurchases, clean balance sheets, high returns on capital etc.), just as poor ones tend to possess certain negative characteristics. No investment is perfect, and will by necessity possess both positive and negative characteristics.

Here at PDV we strive to tilt the odds in our clients' favor by using our knowledge to ferret out those investments whose positive characteristics greatly outweigh the negative ones. Then we make sure we buy these attractive investments at a favorable price. Why is price important? Because the price you pay determines what kind of return you might get. ***Overpaying*** for high quality may have the same negative effect on your return as buying low-quality companies. Overpaying for quality is sometimes known as "*price risk*," a poorly understood and very dangerous risk factor that is commonly ignored.

Over the long run, the stock price and the business value of a company generally converge and the two tend to track each other very closely. Over the short run, stock prices almost always deviate substantially from underlying business values. In periods of over-optimism (greed), the price is likely to exceed the underlying value. Conversely, during periods of over-pessimism (fear), the stock price is likely to fall below the business value, sometimes substantially. Let me give you a hypothetical example of how the price you pay matters a great deal, even if you're investing in a high-quality company.

Let's assume a high-quality company's business value is currently $100 per share. Scenario number one: we're in the midst of over-optimism, and the investment herd has driven the stock price up to $150 per share (because it's a very popular investment). Scenario number two: we're in the midst of over-pessimism, and the stock price of this company has been pummeled to $70 a share (because few people want to buy it due to near-term uncertainties). This company is experiencing average growth in its business of 12% per year

compounded (though the growth may not be even every year). Its business value is therefore also growing at 12% a year compounded on average.

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Based on these hypothetical facts, this company's business value would double to $200 a share in six years. Since intrinsic business value and stock price tend to converge over the long term, we'll assume for illustration purposes that the stock price will also equal $200 per share six years from now. If you bought the stock at $150 per share when the herd was widely optimistic during one of the company's better years, your total return over the six-year period would have been 33% (an unimpressive return despite buying a very impressive high-quality company that grew quickly). If you had bought at $70 per share, your total return would have been 186%! It's the same company, but the price you pay for it makes all the difference in the world on your investment return. ***Even more drastic overpayment for high quality can in fact lead to losses over time!*** Another way of looking at the above example is to think of it as trying to get the most business value at the cheapest price. Mason Hawkins, the legendary investment manager at Longleaf, has coined the term "price-to-value" ratio to measure this concept. The lower this ratio, the bigger the discount you enjoy when you make your investment, and the larger your long-term return potential as the discount closes over time due to the eventual convergence of price and value. In addition to closing of the discount, you may also benefit from the increase in the business value of the company as it grows over time.

While this concept of a price-to-value ratio is easy to state and comprehend, it's extremely difficult to effectively ***execute*** an investment strategy based on it. For most people, emotionally it's much easier to buy the company at $150 a share. This is because the purchase can be made during a period of positive consensus about the company, which helps reinforce the wisdom of your purchase decision. It will be much more difficult to buy the company at $70 a share (when pessimism pervades and you lack the comfort of a consensus). To have the courage and "stomach" to buy the stock amidst doom and gloom, you need to have the requisite knowledge to determine the approximate current business value of the company, before you can calculate the price-to-value ratio. Once you've made this determination, you need ***emotional discipline*** to block out all the negative short-term sentiment about the company and the ***courage*** of your convictions to follow through on your research and conclusion by acting against the consensus.

Here at PDV, we aim to apply our ***knowledge, courage*** and ***emotional discipline*** to ferret out and take advantage of attractive investments with low price-to-value ratios. This is the essence of our contrarian investment strategy that strives to tilt the odds of success in our clients' favor. While no singular investment strategy, including even the best executed contrarian strategies, will work all the time, we believe contrarian strategies tend to offer our clients much better odds for long-term investment success.

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