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PDV *OBSERVATIONS*

Value Investing Will Shine Again

Value investing has been out of favor for much of the past few years. Recently, I wrote a memo to PDV clients reaffirming the superior long-term efficacy of value investing and why it'll shine again. I've reproduced parts of the memo below in this issue of ***Observations***, with the confidential portions edited out. I hope you will find the following observations and comments interesting and helpful in putting the current market environment in perspective.

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"As you know, PDV uses a value-driven investment style to accumulate wealth on your behalf over time. Value investing has been pronounced obsolete, because it has been out of favor for much of the past few years. Many are chasing stocks that seemingly go straight up, but about which they know little or nothing. This is the essence of ***momentum "investing"…*** and it's working, attracting an ever-growing throng of followers who swear by it. Is it sustainable and should I adopt it for you? I respond below.

I believe clients' interests are best served when I'm patient, but not stubborn. I recognize it's important to remain flexible and receptive to new information that might require adjustments to my previously held beliefs. Constantly I challenge myself to critically evaluate whether momentum-based investing, given its strength over the past few years, is indeed better over the long run than value investing. If so, I should embrace it as so many have done. But each time, I come to the same conclusion - **value investing is superior over time** and historical evidence amply supports this. Since the progress of your wealth accumulation depends on the efficacy of this approach over time, I want to explain why I think value investing will shine again and how I've positioned your account(s) to build long-term wealth using this investment style.

Momentum-Driven Strategies Are Working Now - But Fail Over Time

- ***When tested over full market cycles, momentum strategies fail.***

Momentum investing buys what's going up the fastest; how much you pay is irrelevant. It has been working wonderfully over the past few years, but it has proven to be a lousy strategy *over* time. Just because an investment style is working now does not per se make it a good strategy for the long haul. Over any randomly chosen time period, any investment style can work. Even bad strategies will work some of the time, but they fail over time***. If one happens to judge a bad strategy during the***

Thanks for Your Referrals

*As we conclude our fifth year of publishing **Observations**, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past few years. We always welcome the opportunity to be of service to relatives, friends and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past five years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!*

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time period when it's working, one might naturally, but erroneously, conclude it's a good strategy.

Value-oriented and momentum strategies go in and out of favor, resulting in alternating periods of outperformance. This pattern has repeated time and time again throughout investment history. Ideally, I suppose being able to anticipate and switch styles at the right time would produce the best results, but I have not found or heard of any person who's able to do this consistently, as the period of outperformance for each style differs each market cycle. Every investment style likely experiences alternating periods of outperformance followed by more lackluster periods. How well you do when your style is in favor and, equally important, how you do when your style is out of favor will determine your long-term results. ***Only by going through a period of disfavor can investment styles that are working right now be tested to see whether it's a case of "the emperor has no clothes." Over complete market cycles, momentum-based investing has one of the poorest records because it tends to do terribly when the style is out of favor.***

❖ ***Momentum-based investing is benefiting very few stocks; value investing is not alone in being out of favor as we're in a bear market***

Contrary to reports by the press and media, we're currently in a bear market. Even momentum-based investing is only working for a very small group of stocks; value investing is not alone in being out of favor, as nothing much is working right now. The press/media persist in calling this a bull market because the brokers keep saying this. Since brokerage companies make a lot more money in bull than bear markets, uttering the words "we're in a bear market" in public would be a show-stopper, a real "no-no".

The widespread use of the Nasdaq, S&P 500 and the Dow index quotes to gauge how well the market is doing has added confusion and distortion. In reality, these indexes *in no way* reflect the *broad market of over 8000 stocks.* For example, on December 9, 1999, all 3 indexes rose very strongly. However, for every stock that went up, two went down. The number of stocks hitting 52-week lows on the NYSE (422) swarmed those hitting new highs (109) on that day.

These indexes are in fact influenced disproportionately by only about 50 or so predominantly large companies. These 50 or so stocks are performing spectacularly, but *they are only a very narrow sub-segment of the broad market.* It's noteworthy that the December 12, 1999 edition of the LA Times stated that only 11 companies (out of a possible 500) accounted for all the gain of the S&P 500 in the first 9 months of this year. The Nasdaq consists of over 4400 companies, where the largest 5 (yes, just 5) companies are accounting for much of the index's movement!

❖ ***Why don't I just buy these 50 or so high-flying stocks for you***?

I could probably give your account a *short-term* boost by chasing these overvalued stocks like everyone else since I know which ones they are (and frankly my job would become much easier because *it requires little thought, knowledge, analysis and/or judgment*). *So why don't I, since chasing them would not be difficult or require any special insight or ability, and any short-term boost to your account would make me look good and increase PDV's management fees?* Simply because what may *look* good now will likely end up hurting you later. Those of you who work for public companies might be able to relate. It's like your company being short-sighted and cutting let's say research and development outlays to look good to Wall Street, but jeopardizing the long-term competitive position of the company and endangering your retirement benefits. I'm reticent to embrace any "strategy" that has *high odds* of harming you over time, regardless of how well it's working right now**.** ***I'm not interested in having your account "play now, pay later."***

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Because momentum investing ignores the price being paid in relation to the underlying business fundamentals, it'll lead to steep (and perhaps permanent) losses when sentiment changes (often suddenly), as the underlying business value is inadequate to support the stock once it falls out of favor. While all stocks will fall from time to time, momentum stocks rely on sentiment and emotions to prop up prices or support a price rebound, while value stocks have the benefit of higher business values to support their eventual rebound. With momentum investing it is therefore critical to know when to get off the self-fulfilling upward price spiral before it crashes. Nobody can consistently time this, despite many self-serving proclamations by pundits to the contrary. It would be irresponsible, imprudent and frankly presumptuous of me to try to do the impossible. I wouldn't gamble with my own money in this way, and I certainly don't want to gamble with yours by chasing these stocks regardless of price and praying we can get out before everyone else. ***Nor do I want to commit your hard-earned funds into investments whose success depend completely on investor irrational behavior continuing to bid overvalued stocks ever higher. I believe it's my job to exercise rationality when making investment decisions on your behalf, not guess or rely on how irrational others might become.***

Somewhat ironically, many of the companies selling for "dreamy" valuations right now are high-quality companies, giving the whole mania a false aura of respectability (aka "how can one lose buying General Electric?") I've heard assertions that momentum-based strategies are safe as long as you apply them to high-quality companies, as there's no such thing as overpaying for a good company. However, even high-quality companies have a finite worth and you should not overpay a price above this worth.

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❖ ***Value Investing Works Well Over Time***

I'm loyal to value investing because ample evidence shows it's a winning strategy ***over time.*** It's practiced by some of history's most successful investors (Sir John Templeton, Bill Ruane and John Neff, to name a few). Since no singular investment style, no matter how good, works all the time, the fact that value investing experiences lackluster periods from time to time is to be expected and does not detract from its efficacy over time. History has shown value investing to do very well when it's in favor and, may be more importantly, to hold up much better when out of favor than momentum investing. The current malaise affecting this style of investing, while protracted, is not unprecedented. During every past lackluster period, many skeptics wrote value investing off only to see its resurgence each and every time. This time will be no different.

Why does value investing work well over time? ***Because it takes advantage of two factors that don't change over time: (A) human psychology of fear and greed cause over-reaction in both directions in the short term (vacillating between excessive optimism and pessimism), and (B) stock prices over the long term are determined more by business fundamentals than human psychology.***

Historical evidence has proven that stock prices track underlying business results in the long run. Since 1926, stock prices have tracked earnings growth and interest rate movements remarkably closely, on which business values are primarily based. ***Stocks' 11% or so annual compounded return since 1926 consists of roughly 6% annual earnings growth of corporate America, together with about a 4.5% annual dividend yield, with the remainder accounted for by interest rate movements. Over any randomly selected time period, stock prices can and do race ahead of these business yardsticks (during periods of excessive optimism) and fall behind such yardsticks during periods of excessive pessimism.*** But there's little doubt that stock prices and business values converge over time. Short-term psychology of fear and greed will cause stock prices to fluctuate much more than the value of the underlying companies***.*** ***These two facts together create numerous situations where the short-term stock price might fall way below the long-term***

probable business value for a company. By buying at a price below the business value and having patience, value investing creates appreciation potential resulting from the convergence of price and business value over time. With a growing company, the business value will continue to grow, resulting in further appreciation potential.

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❖ ***Some Final Thoughts and Observations***

To some, I may *appear* foolish to refrain from chasing the momentum stocks that are working right now. It just *seems* so easy. But, I'm not interested in making your account look good in the short term; I want to build up a portfolio of undervalued stocks that will serve you well over time. It's uncertain how long it takes for value and price to converge in any particular situation. Therefore, I invest at a price well below what I think is the value to compensate for this. I have experienced many instances where patience and emotional fortitude over several years with respect to slow-moving undervalued stocks were suddenly and amply rewarded and vindicated over a few short weeks or months.

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So next time one of your neighbors, friends etc. baits you into a rat race and tries to make you envious of how fast he/she's sprinting, just remember that after complete market cycles, I expect you'll have the last laugh when you cross the finish line looking back.

I believe much of conventional Wall Street wisdom adds little value, since it is designed to allow those dispensing the advice to avoid looking foolish near-term, often to the actual long-term detriment of their clients. They all like to parrot each other's advice, and chase the same stocks because if the stocks don't work out, they can all hide behind the fact all their competitors were wrong as well. Right now many novice investors and herd-following professionals are all chasing the same small select group of stocks. Warren Buffett once astutely remarked that "most [investment] managers have very little incentive to make the intelligent-but-with-some-chance-of-looking-like-an-idiot decision." I agree.

In contrast, I'm willing to *look* foolish and dumb near-term if it *actually* means doing something intelligent for you in the longer run. I accept the fact that the "cost" of doing the right thing for you is that I might look dumber than I really am over any time period in which value investing is out of favor, depending on the vagaries of the stock market over which I have no control.

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I will continue to be open to new information that might challenge my conviction for value investing, but so far nothing has shaken my confidence in this time-tested approach."