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PDV *OBSERVATIONS*

A Post-Mortem: Momentum Investing Gets a Failing Grade

Rewind twelve short months ago. The tech and momentum bubble was super-inflated, qualifying as one of the biggest manias in investment history. Investors, amateur and professional alike, were abandoning value investing and value stocks in droves, all piling on and chasing the bubble. It was self-reinforcing while it lasted. Some value investment managers with good solid long-term records were forced to close up shop due to massive redemptions, while many others without the requisite emotional fortitude transformed themselves overnight into momentum "investors." An apt motto for the times seemed to be "don't worry, be happy!"

Given such an environment and knowing some of our clients were under immense peer pressure (is there a stronger type of pressure?) from their friends, colleagues, neighbors and/or relatives to join the momentum crowd, our disciplined (and some would argue, stubborn) focus/emphasis on risk management, business valuation and the need for reasoned security analysis, must have seemed hopelessly antiquated. Remarkably, these hard-to-accept investment principles were backed up by over 70+ years of investment history and would have easily passed as good old common sense during more sober and rational times.

Bracing for possible criticism and controversy, I nevertheless wrote a memo to PDV clients at the time, warning about the long-term negatives of momentum "investing" and how it would end badly (as it has always done):

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

Every investment style likely experiences alternating periods of out-performance followed by more lackluster periods. *<u>How well you do when your style is in favor and,</u>*

Thanks for Your Referrals

As we conclude our sixth 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 six 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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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*** (emphasis added).

At the time I wrote those words, value investing was struggling through one of its worst periods ever. In stark contrast, momentum "investing" was experiencing one of its best stretches ever. I had little doubt that better days were ahead for value stocks, while momentum and overvalued tech stocks would be hurt very badly on the way down. History has repeatedly shown that momentum strategies always do terribly when the style is out of favor, giving back most, if not all, of the gains made during the good times. I therefore strongly encouraged clients to reserve judgment on the efficacy of momentum investing, until it had been tested during difficult times, as value stocks had already done. Events unfolding since the NASDAQ topped out in March 2000 have now confirmed the downside risk of momentum "investing," as the NASDAQ has dropped so hard that it's below the level at which the former parabolic rise took off.

Prior to the severe NASDAQ drop, it would have been oh so easy for us here at PDV to join the momentum crowd, as that was the path of least resistance. It almost certainly would have made us look good to our clients in the short term. Money is not difficult to make in a speculative market environment, but it's difficult to keep. We wanted to do the right and prudent thing for our clients by delivering sustainable long-term wealth accumulation. I explained my thoughts at the time as follows:

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 (emphasis added). *…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"*** (emphasis added).

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 (emphasis added). *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*** (emphasis added). 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.***

By refusing to participate in the bubble (which probably made us look foolish in the short run), we helped our clients avoid the "steep (and perhaps permanent) losses" that I referred to above that have now hurt the shareholders of all those Internet companies that have gone out of business, as well as those viable companies that sell for a fraction of their formerly absurd prices. With the euphoric and speculative

sentiment gone, the stock prices of these companies are highly unlikely to see their former highs, because the underlying business values are simply inadequate to support that drastic a rebound in price. As such, these price drops cannot be treated as the garden-variety cyclical declines that bounce back when business or the stock market improves. They have become permanent losses.

In the same memo, I also cautioned against thinking these problems were isolated and confined to just highly speculative dot-com companies:

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 (emphasis added).

Again, hindsight has shown that the list of high-quality, but formerly overvalued, tech stocks that have dropped over 50% from their highs is a long one indeed. These stocks could reach and eventually surpass their former highs as their underlying business values grow over time, but will likely take a long time before doing so because previously their stock prices ran so far ahead of their business value. The fate befalling these stocks once again shows a high-quality company can be a lousy investment if you overpay for its shares because consensus thinking lulls you into a false sense of security.

Emphasizing that long-term wealth accumulation is a marathon rather than a sprint, I continued with the following:

…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…

…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…

As events unfolded over the past 12 months, our focus on valuations and refusal to participate in the bubble have helped PDV clients ***preserve*** as well as ***accumulate*** wealth during that period.

The masses still holding overvalued stocks (many of which are tech companies) are trying to console themselves nowadays by seeing a NASDAQ bottom around every corner, followed by a swift V-shaped recovery. While I take no joy in seeing the incredible wealth destruction among the herd-following masses, I think that's very much wishful thinking on their part. To understand my thoughts on this, please turn to the following article.

NASDAQ AND TECH STOCKS: THE BOTTOMLESS PIT

At its worst point recently, the NASDAQ (which is pretty representative of what has happened to overvalued tech and momentum stocks) had dropped close to 55% from its high reached in March 2000. Lots of people got caught up in the mania on the way up. Some of these people have now sold out for breathtaking losses. Some made these sales voluntarily to cut losses that became too painful to bear, while others were sold out involuntarily through margin calls. Of

those still hanging on, there appears to be a lot of rationalization going on. These investors continue to see a NASDAQ bottom around every corner, followed by a V-shaped recovery.

Here at PDV, we do not believe the NASDAQ bottom has been established. In fact, we believe it will see further declines from here. Let's explain our reasoning.

There is no investment "law" that says a stock price must eventually recover to its former highs. Stock prices eventually track business prospects. With respect to the typical dot-com company with no viable long-term future and selling at a fraction of its former high price, the loss can be considered permanent, as sentiment has soured and its business fundamentals are well short of what's needed to support any meaningful stock price recovery. There are many tech companies whose greatly reduced stock prices still over-value their long-term business prospects.

Also, the NASDAQ bubble was attributable to several factors that no longer exist. Spending on technology was aberrationally high in the 1998-99 period because of Y2K concerns that have since passed.

In addition, a lot of traditional bricks-and-mortar companies felt they had to spend heavily on technology to defend their market positions against free-spending dot-com companies that were financed by the easy IPO money. Of course, predictably the brokerage companies did their part to shamelessly grease this process. The dot-coms' investments in technology were not made based on cost/benefit analysis because it was so easy for the dot-coms to keep accessing the capital markets for more of the public's money.

Now with the demise of so many dot-com or "New Economy" (doesn't this term sound silly now?) companies and the capital markets shut tight, the traditional companies have cut back on their tech spending, as the perceived threat from the dot-coms has receded. I expect tech spending will be below trend for a while, and that bodes ill for many tech stocks that still sport huge valuations.

In fact, I don't expect the NASDAQ to reach a bottom until several things occur. First, margin debt must be greatly reduced. Incredibly, margin debt is still at astronomical levels, especially in relation to shrinking asset values. Second, "go-go," momentum and tech-oriented funds must experience massive redemptions for a bottom to be formed. Such redemptions, while accelerating recently, are still nowhere near the panic levels that are required to establish a bottom. Third, people have to stop expecting a bottom, and begin to despair that the bottom is nowhere in sight. That's when the bottom will be formed.

Notwithstanding our bearish stance on the NASDAQ in general, its savage drop has created selective tech bargains. Here at PDV we have begun building positions in these for our clients. We expect them to do well, regardless of the short-term direction of the NASDAQ.

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