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PDV *OBSERVATIONS*

529 Savings Plans: Not Quite a Free Lunch

The tax legislation passed by Congress last year contained something beneficial for just about everyone. Among other things, it expanded the tax-advantaged options for funding college expenses by eliminating federal taxation of earnings generated inside 529 Education Savings Plans, starting on January 1, 2002. Here are the pros and cons that you need to know about these plans.

Benefits of Such Plans

1) Anyone can set up this type of account and you can name anyone as a beneficiary;

2) Unlike Educational IRA's, there are no income limits on how much you can contribute to these plans each year, though gift tax limits do apply; however, there is a provision that allows acceleration of 5 years' worth of gift tax limits upfront;

3) The tax-exempt earnings together with the contributions built up in these plans can be applied to a wide variety of colleges around the country and a broad group of educational expenses beyond just tuition;

4) You may transfer the 529 account to another eligible beneficiary, if the initial intended beneficiary decides he/she doesn't want to attend college; and

5) You can invest substantial amounts of money in these plans over time; some plans will allow investment of up to as much as $240,000 over time for any single beneficiary.

Possible Disadvantages

1) Most 529 plans offer a very limited number of investment options, managed usually by one single mutual fund company. You will therefore not get best-of-breed investment options, like you would if you were to invest outside a 529 plan in a much wider menu of mutual fund options. Since no single mutual fund company has a monopoly on investment wisdom, my expectation is that the investment results from most of these plans will likely be mediocre, lagging the investment returns that are possible outside plan accounts.

2) 529 plans generally do not allow for reallocation of investments among the different plan options with respect to any contributions that have already been invested. However, there are ways in which PDV can address and mitigate this disadvantage for you.

3) These plans may adversely affect your eligibility for financial aid down the road. While the legislation treats the person setting up the account as its owner for control purposes, it is currently unclear whether financial aid programs might deem the money in the account to be owned by the beneficiary. This is a concern because many such

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programs "penalize" student assets more than parents' assets when determining eligibility. Of course, if you successfully accumulate substantial assets in a tax-advantaged manner inside these plans, then it may not concern you that you might no longer be eligible for financial aid.

After considering the foregoing pros and cons of 529 plans, please contact us at (310) 559-0898 or pdvfinmgt@aol.com if you think you may be interested in using these tax-exempt plans to get a head-start on funding future educational expenses. We will show you how we can help.

Expect Tame Market Returns for the Next Few Years

Those familiar with PDV's investment philosophy know that we are firm believers in the concept of "regression to the mean." The markets, economy, corporate profits and companies all go through cycles. Annual stock market returns over the past five years have regressed towards the long-term mean of around 10.5%. More recent returns have now regressed far *below* that mean. This is not surprising as stock market returns fluctuate around the mean, but tend to overshoot in both directions. Here at PDV, we believe that stock market returns will fall below the long-term historical average for the next few years. To see why, it is important to understand what drives stock prices.

The 10.5% average annual return since 1926 is made up of 3 components: 1) return-on-equity ("ROE") of corporate U.S. as a whole, 2) return from dividend payouts that are not reinvested into the business, and 3) returns resulting from p/e multiple expansion. The higher each of these components is, the better for the market.

Let's examine the likely direction of each of these components in the next few years. First, it is unlikely that ROE's will approach the historical average of 12% any time soon. The economy is still mired in recession, although there are some incipient signs of a slow and shallow recovery. But overcapacity still exists in many areas. Given the excesses in the latter half of the 1990's that need to be worked off, it will be quite some time before ROE's start approaching 12% again.

Second, market dividend yields are currently way below historical averages. While some of this can be explained by companies opting for the more tax-advantaged method of enhancing shareholder value by buying back shares rather than paying out taxable dividends, the dividend yield is still very low by historical standards even after taking this factor into account.

Third, the long-time historical average p/e ratio of the market is around 14-15. Right now, the p/e ratio of the market is about 25, depending on how one defines the market and earnings. Here at PDV, we believe 2001 earnings were abnormally low because of the recession, and therefore we believe normalized earnings are in fact higher. However, even with this adjustment, the market p/e ratio would still be higher than normal. Given how low interest rates are already, it is more likely that they will rise rather than fall in the next few years. The market will be less able to sustain the currently higher-than-normal p/e multiples, resulting in some p/e multiple contraction and hurting the market.

From the foregoing, it should be clear that none of the three major components that determine stock market returns are currently favorable. There is only one conclusion: for the next few years, the returns from the stock market are likely to fall below the historical average of 10.5% a year. Our guess is that the market will not provide more than a 5-6% annual return during that time span.

However, undervalued securities exist in any market, and those who are willing to think independently from the market and seek out such opportunities have a good chance of getting better returns. This is what we believe we can do for our clients here at PDV. The days of trying to get rich by mindlessly following the crowd and investing in what's popular when it's popular are over.

PDV STOCK-PICKING PRINCIPLES

PDV was blessed with many new clients last year, ***as assets under management reached a new record!*** Many have expressed an interest in knowing in more detail the principles by which PDV selects promising investments for its clients. While existing PDV clients and long-time readers of *Observations* are very familiar with these principles, I thought it would be useful for our new clients if we reproduced an article we wrote on this subject back in 1997. These principles have not changed; they have served as the foundation for our clients' very satisfactory returns over the past 7 years, notwithstanding going through a wide variety of market conditions during that time. The article follows.

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Here at ***PDV*** we strongly believe that successful investing requires patience, discipline and a value-orientation. While there are many different investment styles that can lead to long-term investment success, we feel that such styles will at least share the above characteristics. We have developed a set of stock-picking principles that guide our selection of stocks for our clients, which embrace these characteristics. We thought it might be interesting to share them with you in this issue of ***Observations.*** These principles are:

Focus on Out-of-Favor Undervalued Stocks. Successful investing requires identifying not only good companies, but also those selling at reasonable prices/valuations. *Bargain* prices (as opposed to *justifiably depressed* prices) are usually only available when a company is having temporary problems, and the investment herd is either 1) wrongly projecting those problems to be permanent, or 2) too impatient to wait for the turnaround. We spend considerable time and effort analyzing and evaluating a) whether the problems are indeed temporary, b) how likely the problems will be solved, and c) what the company might be worth if the problems are corrected. The stock's current price should be substantially less than its potential long-term fair value before we would consider it attractive for purchase.

Patience an Essential Ingredient. Over short periods of time, stock price movements have a very tenuous connection to fundamental business values, and stock prices tend to change a lot more than the underlying business values. Over longer time periods, stock prices tend to closely track the underlying business values. *We try to make the stock price movements our clients' ally.* When prices are well below the underlying business value, we buy for our clients. Conversely, when prices greatly exceed such value, we sell. When we invest in a stock for our clients, generally (but not always) we target a 30-40% return over a ***two-year period***. One should not expect the return to be achieved in an even or stable way (e.g. it's possible the stock might lag for 21 months but make all the gains in the final 3 months), but we generally want to see the stock price at least 30-40% higher at the end of the two-year period. We can't predict exactly how long it will take for a potential turnaround to materialize, but from experience we find 2 years is a reasonable period to allow for a business turnaround. For those investments that work out, some won't take this long, while others will take longer.

Successful Investing Involves Turning Human Psychology on Its Head. Money and investing invoke the most powerful of human emotions, greed and fear. It is risk and uncertainty that make people uncomfortable and engender fear. However, it is important to realize risk cannot be completely eliminated, and investing inherently involves uncertainty. Stocks that people feel "certain" will produce investment gains are nothing more than those about which a consensus exists. Such stocks usually have high valuations that already discount a lot of good news. Any slight disappointment would produce losses. The art of investing is actually about ***managing*** (and not the impossible task of eliminating) risk and uncertainty. *Viewed in this light, we try to exercise* ***emotional discipline*** *to be greedy when others are fearful* ***assuming the risk/reward situation is good****, and conversely we are fearful when others are greedy. This gives us the opportunity to buy stocks cheaply and sell them dearly for our clients.* We like out-of-favor stocks unburdened by high valuations and expectations, where positive surprises are likely.

Adequate (But Not Excessive) Diversification is Good. It is not possible to have a portfolio with nothing but winners. Inevitably, there will be some losers and there's no sure way to tell up front which ones they will be. Our goal is to have sufficient diversification for our clients, so that the winners will outweigh the losers, and generate a reasonable return ***on the entire portfolio*** consistent with our clients' investment parameters. Avoid focusing too much on any single security within the portfolio, and evaluate investment progress based on the portfolio as a whole.

Don't Expect to Catch the Bottom or the Top Because We Seldom Will. We will buy a stock if we feel it is selling at a big enough discount to its long-term fair value so that it has a reasonable opportunity to generate a 30-40% return over a 2-year period. This is the idea of the "margin of safety" embraced by legendary investors like Ben Graham and Warren Buffett. Because we like to invest in out-of-favor stocks, many of them are likely to be experiencing some short-term operating issues that often can (and do) get worse before they get better. Since we don't have a crystal ball, we will not be able to catch the bottom in the stock price. Worsening consensus sentiment could cause the stock price to continue dropping, creating an even bigger discount to fair valuation. Such short-term price drops are generally no cause for concern if one maintains a long-term investment time horizon and the business fundamentals remain intact to justify a turnaround in the company's fortunes. Depending on the circumstances, it may be a good opportunity to buy more. If business prospects turn around as anticipated, then the stock price will follow once investment sentiment improves. We will sell when the stock becomes overvalued. The momentum of improving sentiment could (and often will) drive the stock price even higher after we sell, but we prefer to reinvest your capital in other out-of-favor investments with better risk/reward characteristics going forward.

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