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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Our new website, **www.pdvfinancial.com**, was officially launched in October 2003. Thank you for all your positive feedback. Our site contains a lot of information about investing in general and **PDV *Financial*** in particular. You can get a clear picture about how we think about investments and what we do to help clients achieve their financial goals. Please do take a look at our site at your convenience, and come back to visit us often!

PDV Is Very Different from Other Investment Advisory Firms

By Che H. Lee
President

There are many competent, honest and hard-working investment professionals available to help you manage your hard-earned assets. Many advertise that they are the best candidate for this important responsibility, because they are smarter and do more in-depth research than their counterparts. They also aim to emphasize how they are different from each other. And yet, as a group the vast majority of investment professionals tend to move en masse, generating very mediocre financial results for their clients; in fact it is well established that over time, the vast majority of investment professionals produce wealth accumulation for their clients which lags the general progress of the stock market.

How is **PDV** different from the vast majority of other fee-based investment advisory companies? The major difference lies in our respective incentive systems. In short, many other investment advisory firms are subjected to client pressures to produce short-term investment results, and most of them succumb to these pressures by failing to screen their clients. Here at **PDV** we resist such pressures at all costs. We accomplish this by being willing to control our growth and refusing to take on any client who insists on seeing short-term progress. We feel so strongly about this that, over the years, we have passed on substantial business by refusing to take these types of investors on as clients.

How does this phenomenon commonly known as the short-term performance “rat race” come about? It is a natural human tendency to dislike uncertainty, especially when it comes to matters of money. Psychologically, we tend to address this feeling of discomfort by seeking immediate validation and social proof via consensus. This is well-known within the field of psychology. We want to avoid feelings of regret that somehow we may have made a mistake if the price of our investment goes down *the very next day, even if our time horizon is a lot longer*. We particularly welcome

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social proof--general and widespread agreement among others--that the investment is a good one. Nobody wants to feel like a financial patsy and a lonely one at that.

Many investment advisory firms that cater to retail investors confront this pressure. These firms understand that if their clients don't get instant gratification, they are likely to move on to other professionals. These investment professionals are therefore forced as a matter of business reality to focus on producing short-term results to appease and retain clients.

Investment advisory firms that cater to institutional clients are under even more pressure to produce short-term performance. Institutions exemplify the worst in investor herd behavior, as they generally are loath to select investment advisory firms that do not follow conventional wisdom when investing. Since the investment advisory firm knows this is the client's expectations, they too will get with the program by following the consensus as the safe way to preserve the client relationship.

The ultimate result of both this retail and institutional client pressure being brought to bear on investment professionals is quite predictable--most of them tend to move en masse with little creativity or independent thought, in and out of the same securities at roughly the same time. The only way an investment advisory firm can rationally endeavor to produce good short-term performance is to chase whatever happens to be "working" in the short run. "Working" in this case means upward movement of the stock price, regardless of whether it is justified by the underlying business fundamentals.

This type of investing style that focuses on producing short-term performance, in our view, is destined to produce mediocre investment results at best over time. At worst, it can lead to total financial disaster.

Benchmarking

Related to the issue of short-term performance is the fact that many investment advisory firms are saddled with the mandate that they perform in line with some chosen benchmark, which is often some market index or composite of market indices. Their incentive system usually provides large penalties for lagging such benchmarks, while providing for a disproportionately smaller reward for outperforming such benchmarks. Because to many, the reward of extra compensation that comes from out-performance would not justify the risk of the substantial penalties for under-performing their benchmarks, these investment professionals spend their waking hours doing their best to track their benchmarks in the short run, as opposed to doing what's best for their clients over the long run. Tracking benchmarks involves determining what securities make up the benchmark index and in what weightings, and then buying the same securities in similar weightings for client portfolios. Instead of investing in what is most appropriate for clients, these investment advisory firms are investing according to some arbitrary reference point.

This problem is particularly acute for investment advisory firms catering to institutional clients, who hire "consultants" to select and monitor investment managers. Most of the bench-

marks are chosen by or creations of the consultants, who have to justify their huge consulting fees by creating the illusion of scientific order via these benchmarks. Without benchmarks, they have a much smaller role to play and much lower fees to collect.

Managing money according to benchmarks guarantees mediocrity at best. Why? Because benchmarks tied to various market indices are nothing more than the result of the collective buy/sell decisions of all market participants in those market segments at any one time and their impact on prices of stocks that in the aggregate make up those segments. ***From this perspective, by definition the progress of the market at any time is defined primarily by what the vast majority of market participants are doing with respect to their investment decisions. If you follow the herd, you help define and become part of the market. This is in fact how most money is professionally managed.***

Investment advisory firms that give in to this type of retail and/or institutional pressure for self-preservation (and most do) will see their primary job as serving ***the twin related purposes of producing short-term performance and minimizing any variance of their client accounts from the progress made by the market or applicable benchmarks.*** In this sense, they are mostly focused on reducing "tracking error," as opposed to actually doing what is best for the client in the long run. It is for this reason that it is widely reported and known that most investment professionals produce wealth accumulation progress that lags the progress of the stock market over time. This is because the vast majority of investors by definition constitutes the market, and their progress is essentially the market's progress, minus management fees and transaction and other costs.

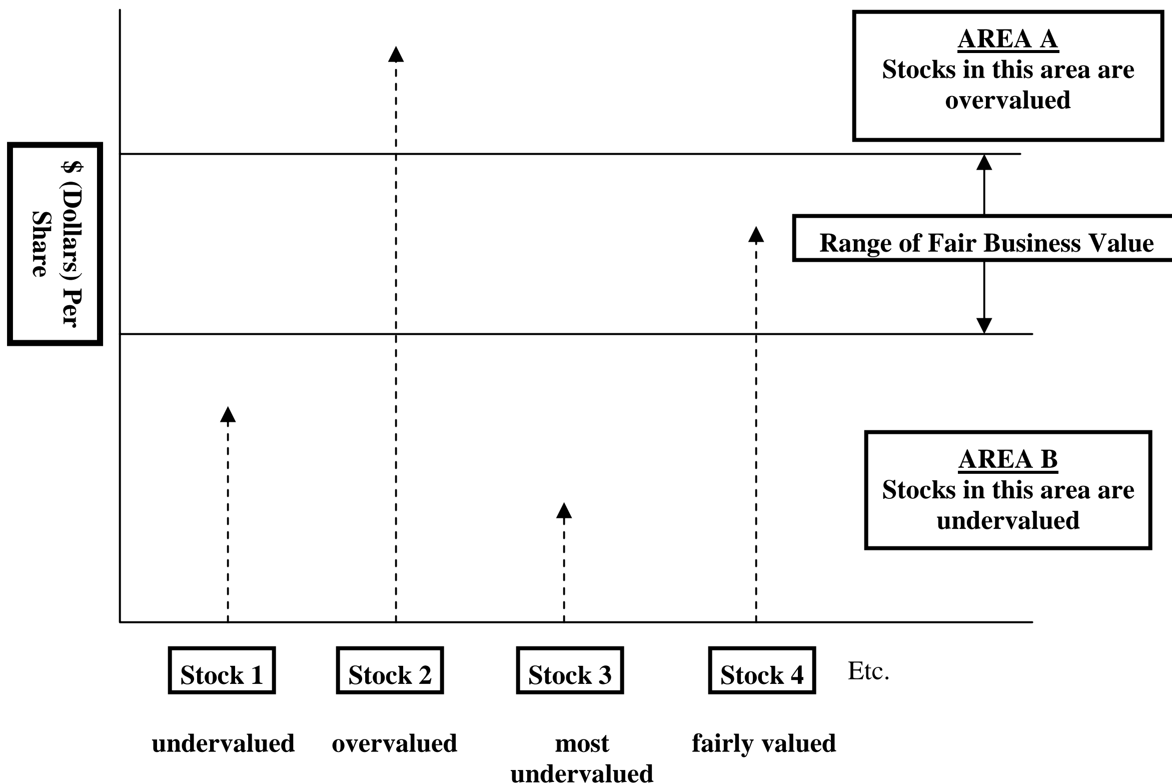
Here at **PDV**, we would respond in the same way for self-preservation if we accepted this type of flawed incentive system or chose to do business with clients who put this kind of pressure on us. Because we do not believe this is a productive way for people to accumulate wealth over time, ***we have decided as a firm to find and select clients who allow us to operate under a different incentive system--one that allows us to forego instant gratification in search of greater long-term benefits for our clients***. By doing this, our clients allow us to invest differently than the vast majority of investors, which by definition means their investment progress will be different than, and hopefully superior to, the market over time.

Overall Portfolio Valuation As Indicative of Future Account Progress

By Che H. Lee
President

The following diagram depicts how the current overall valuation of a hypothetical client portfolio determines its likely progress ***going forward***. The greater the overall undervaluation currently enjoyed by portfolio securities, the more likely the portfolio has recently been lackluster, but future progress via embedded appreciation potential will likely be strong. The opposite holds true when overall undervaluation shrinks after a period of strong portfolio progress.

- An account completely invested in individual equities will typically have anywhere from 15 to 25 stocks. How the client's stocks are distributed among the overvalued, fairly valued and undervalued categories will determine the appreciation potential of the overall portfolio going forward.
- The depiction below shows 4 stocks as an example. Stocks 1 and 3 are undervalued; Stock 4 is fairly valued; and Stock 2 is overvalued. Stock 3 is the most undervalued.
- The more stocks the client has in AREA B at any one point in time, the more likely her recent account progress has been lackluster, as undervalued stocks take time to work out; ironically, the future appreciation potential is the greatest because it is the undervaluation that creates the potential for appreciation in the future. This is a significant reason why clients should not give up on their value strategy after lackluster periods, because that is precisely the time when potential gain is at the greatest. Think of the situation like a coiled spring.
- The more stocks the client has in AREA A at any one point in time, the more likely she just experienced a period of strong account progress, as the stocks rose from undervalued to overvalued levels. At this point, grossly overvalued stocks will be sold ("harvested"), with the proceeds reinvested ("seeds planted") in more undervalued securities, setting the foundation for the next stage of potential capital appreciation. As the client shifts more stocks in her portfolio from AREA A to AREA B, her portfolio will shift from a period of strong progress to another period of slower performance, as "seeds" or undervalued stocks need time to bloom, before they can be "harvested." That is why the client's account progress will go through alternating strong and slower periods.



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