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PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

Regression to the Mean: an Optimistic View

By Che H. Lee
President

Let's cut to the chase: the equity markets have been lousy over the past several years. Consider the following information:

	S&P 500	**DJIA**	**NASDAQ**
Dec. 31, 1999 (6 years ago)	1,469.25	11,497.12	4,069.31
Dec. 30, 2005	1,248.29	10,717.50	2,205.32
6-year annualized return (w/o dividends)	**-2.68%/year loss**	**-1.16%/year loss**	**-9.71%/year loss**

Yes, you read that correctly. The stock market, as represented by the three popular indexes above, lost money over the past 6 years. The NASDAQ was in fact an unmitigated disaster. Even after adding back dividends, only the DJIA (Dow) eked out a very small gain during the entire 6-year period. No wonder real estate has replaced stocks as the topic of choice at cocktail parties.

There may be reason for optimism going forward, however. Data from 80 years of market history show that equity markets almost never lose money over any 10-year period (the last time was in the 1930's). If you compute the average for all annualized rolling 10-year returns over the past 80 years, you get around 10% per year. Given the terrible stock market in the past 6 years since the turn of the millennium, the market would have to gain substantially in the next 4 years to reach the mean annualized historical rolling 10-year return.

Thanks for your referrals!

As we conclude our eleventh 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 year. 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 eleven 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!

Inside This Issue:

If you believe (as we do) that markets have a strong tendency to regress to the mean over time, the odds favor better times ahead. Even if we assume that the mean annualized return for the decade beginning with the year 2000 will be at the lower end of the historical spectrum, the potential returns from here over the next 4 years should still be much improved. So, if we go with the odds of market history, the frustrating period of the past 6 years is potentially setting up for a decent, much improved period in the next 4 years.

Why do markets have a strong tendency to regress to a mean? Here at PDV we think this is because markets are quite efficient in the long run in measuring underlying business value creation and progress. In contrast, in the short run mass psychology causes random, inefficient markets. The mean annualized 10% return figure has a value basis in that it approximates corporate America's cumulative growth in profits through earnings retention and reinvestment, plus the dividend payout, averaged over time.

Some will correctly point out that economic conditions have evolved greatly over time, with this change accelerating in the past few years due to the Internet etc. Because of this, these same people may rightly question whether historical economic progress or value creation over the past 80 years can offer a useful guide for what lies ahead. For example, they might assert that costs have been cut to the bone, so there is less opportunity for similar cuts in the future.

Absent any unforeseen transformation, we agree with the perceived limits to further massive cost-cutting. This suggests short of some real revenue growth, corporate America is not going to do well enough going forward to generate business progress that justifies and supports a continuation of historical mean returns. But having said that, corporate America, imperfect as it is, seems to be self-correcting and adapting over time. This has been proven over history, time and time again. For example, most of us didn't come to anticipate the advent of the Internet and its revolutionary impact on reducing costs, nor did most of us predict that costs could be further cut by shifting more and more manufacturing overseas. Yet now in hindsight, these developments are completely and firmly embedded in our economic systems at this point. Who knows what lies ahead that will allow corporate America once again to adapt?

It is true that just because odds are favorable that something will happen does not dictate that it must happen. However, even if the equity market over the decade starting in the year 2000 only produces a return at the low end of the historical rolling 10-year mean return spectrum, the prospects over the next four years for the equity market should at least be quite a bit brighter than the past six.

The Brouhaha Over Hedge Funds: Caveat Emptor

By Che H. Lee
President

Hedge funds have become very popular over the past few years. We think there are several reasons for this. First, many hedge funds promise market neutrality, striving to produce positive returns, regardless of what is happening to the general markets. This is naturally very appealing during a lousy market period (see above). Second, most hedge funds (at least until recently) have high admission minimums, attracting those looking for a sense of exclusiveness and privilege. Third, a small select group of hedge fund managers have been producing spectacular returns, perhaps causing people to think it is *the vehicle of* hedge funds, rather than *who* is running the fund, that is responsible for the stellar returns. Fourth, hedge funds are allowed to short securities (if that is their strategy), offering flexibility that is not available to many mutual funds whose mandates prohibit shorting. Again, this ability to short (or to benefit from falling securities) is attractive during a period when the markets have gone nowhere fast, and in fact have experienced some spectacular drops along the way.

A few clients have asked whether hedge funds have a place in their accounts. To date, we have not put any clients in hedge funds. In our view, there is nothing special about hedge funds *as a group* (notwithstanding what we all read in the popular press). It is a myth that hedge funds as a whole are "smart money." Only a small portion of the hedge fund industry is stellar, which is true in any profession. For those select few hedge fund managers who are superior, they are indeed very, very good.

Hedge funds do have some advantages over mutual funds if run by skillful practitioners -- they are able to use more investment tools (with less restriction and disclosure) to their clients' advantage. However, those same tools, in the hands of the unskilled or dishonest hedge fund manager, can be deadly. Notwithstanding the recent requirement that hedge funds register with the SEC, this will not eliminate the secrecy shrouding what they might be doing with your money from time to time. If the hedge fund managers are good and honest, you need not care about such secrecy; if they are incompetent or dishonest, it will be more difficult to discover problems versus mutual funds whose required disclosures are better. In any event, many of the largest hedge funds are circumventing the registration requirement by lengthening their “lock-up” period, during which time limited partners have restricted or no right to withdraw their funds.

A few years ago, some of the best mutual fund managers moved to hedge funds for a variety of reasons. Many others have since followed their footsteps. The hedge fund field has now become too crowded, with many people doing the same trades. The good people are still able to produce superior results, but now there are a lot of mediocre or incompetent managers in the hedge fund world as well. In fact, we expect hedge fund returns as a whole to go down just as it has become increasingly popular to pile into them. The top-notch hedge fund managers will continue to more than justify their generally high fees, but they tend to be the ones with very high entry minimums. There are many “fund-of-funds” available now with low entry hurdles, but often you get what you pay for. Two words come to mind if you are considering hedge funds: *caveat emptor.*

The Curse of Perfection

By Che H. Lee
President

Naturally we all want our equities to produce “ideal” investment results, with the following characteristics: strong, predictable, consistent returns without volatility. In other words, ideally we all want our equities to perform like super-charged CD’s on steroids. Oh yes, wouldn’t it also be nice if our equities “beat the market” all the time?

It is one thing to desire this ideal, but quite another to expect it. Equity investing is at its core about predicting the future. Perfection is unattainable when it comes to investing, and nobody (we repeat nobody) beats the market all the time. You would be well-served to keep this in mind in managing your expectations.

All this is not mere semantics. If you think perfection (or near-perfection) is achievable when investing in equities, then any deviation from this unrealistic expectation becomes a potential reason for second-guessing and a possible trigger for change. Of course, we can all improve our investment processes, but this is not the same as seeking or expecting perfect investment results.

We suspect few investors would be willing to show their naivete and admit they expect perfect investment results from their equities. And yet, when a stellar investment strategy (which we define as one among the select few that "beat the market" over time) inevitably deviates from the perfect scenario by producing volatility and losses and lagging the market, there is often a strong tendency to want to make changes to the strategy sooner rather than later. If one is to truly accept that even the very best equity investment strategies produce volatility and losses, and experience lagging periods, then one is less likely to abandon a stellar investment strategy, just because it does not fit the mold of a perfect investment portfolio.

Patience and discipline, as always, are key to profiting and benefiting from outstanding investment strategies, since even the best strategies can look downright pedestrian for frustratingly long periods. For example, the best investors in the history of investing (like Bill Ruane and Charlie Munger) have lagged the markets from time to time, sometimes for multi-year periods. Many of these superb investors who beat the market over time (when the measurement or snapshot period is sufficiently long) only do better than the market 60-70% of the time, when the measurement period is a calendar year. Even Berkshire Hathaway (which is managed by Warren Buffett), has lagged the market from time to time, despite absolutely trouncing the market indexes over a 30-year period.

It is true that Bill Miller at Legg Mason has just beaten the S&P 500 for the 15th consecutive year. I suppose one can argue he has come close to beating the market all the time, if "all the time" consists of time periods of exactly one calendar year each. However, Miller has in fact lagged the S&P 500 for quite a few 12-month periods during those 15 years if the calendar-year measurement period is shifted just slightly to a different arbitrary 12-month period. Miller is a highly talented investor, but he would probably be the first to admit he has not beaten the market "all the time," though he has done better "over time."

Unfortunately, there is no fool-proof way of determining whether a strategy that is currently lagging the market is one that will be among the select few that beat the market over time. However, the discussion above shows that having a lagging period does not <u>by itself</u> have any probative value as to the long-term market-beating potential of the strategy. For market-beating strategies that have been tested under many different market conditions and over an extended period of time (let's say 7 to 10 years), lagging performance over shorter interim periods should not be enough of a reason by itself to abandon the strategy, as long as the same strategy that produced the market-beating results over the longer term is still being consistently and faithfully executed. We just cannot emphasize this point enough!