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The Value of Patience

...continued

Before closing, we should note that statistical analysis such as Ibbotson's must take a mechanical approach to classifying stocks. Ibbotson relies on the ratio of market value to accounting (book) equity in order to distinguish stocks as "value" or "growth". Stocks which trade at low multiples of their book equity are defined as value stocks. Value managers such as ourselves take many more factors into account, with the expectation that investment returns will exceed those from a single factor approach. We can't promise that, but that is our goal.

We believe that successful long term investing means playing the probabilities. Although history demonstrates that value investing periodically underperforms "the market" and growth style investing, investors with patience recognize that the odds are on their side when they invest in value stocks. It often takes iron determination to persevere with value investing, but in the end we think it is the best way to achieve investors' objectives. ■

Intrinsic Value

...continued

calculation of value depends completely on what someone else is willing to pay, making it quite uncertain.

However, unlike a painting, where the benefits of ownership aren't measurable, when you own a business, you collect the profits – measured in dollars. Even when you don't own enough of the business to control it, as a shareholder, you still own the profits. With a good business that's shrewdly and ethically managed, you should be happy with the way your profits are controlled. You agree that it's better to have a sizeable portion of your profits reinvested for *growth* rather than have them all paid back to you in dividends.

So if a business is consistently profitable, it's like a castle with a large moat, with sustainable competitive advantages that make future profits much more certain. These types of businesses are relatively easy to value. Owning a profitable business is like owning a bond with a rising coupon. It has value that doesn't depend solely on what someone else is willing pay for it, and can therefore be calculated with a high degree of certainty.

In the volatile stock market, these types of companies become great investments when they sell significantly below their values, which they are prone to do - thanks to the whims of the market. The key to success is to always use your paddle and listen for the roar of the waterfall. ■

Note 1. Berkshire Hathaway 2006 Annual Report, page 77, italics added.

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INSIGHT AND OUTLOOK

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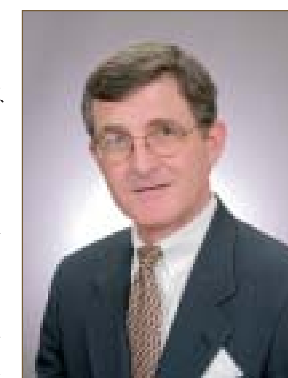
The Value of Patience



by Bill Miller
Patton Albertson & Miller, LLC

The 25th anniversary of Great Britain's Falkland Islands War with Argentina in 1982 reminded us of what an exceptional leader Margaret Thatcher was. The strong-willed "Iron Lady" had the determination to pursue her objectives no matter how long it took. She once said, "I am extraordinarily patient, provided I get my own way in the end."

Patience contributed to her success in politics, and we think patience can assist investors in achieving their investment objectives as well. Patience combined with a proven investment approach offers a sensible way to preserve wealth and to grow it prudently in the future.

Patience and Value Investing

Value investors attempt to identify companies which are trading below their "intrinsic value", the price a knowledgeable businessman would pay for the entire business. (See John Healy's article on page 3 for more discussion.) Two challenges confront the intrinsic value approach to investing, one at the individual stock level and the other at the portfolio level. At the individual stock level the market sometimes takes several quarters to recognize the true value of a company. If we buy shares of an undervalued company too early, our clients' patience is tested. No one likes "dead money" which is one reason we prefer dividend paying companies. At least then we get paid while we wait for the value to be discovered by other investors.

At the portfolio level sometimes the market favors growth stocks or speculative stocks to such a degree that value investors' annual returns appear paltry in comparison. Again, our clients' patience might be tested, especially if the speculative investment environment persists for more than a few quarters.

Some investment management firms deal with these difficulties by blending value investing with growth investing. In Wall Street jargon, they use multiple "styles". We are convinced that our undiluted value approach should provide better long term performance, and we have the data to support that conviction. But first, let's consider the challenge at the individual stock level.

Stock Challenges

Perhaps the simplest way to appreciate the challenges at the stock level is to study the following idealized graph.

The smooth black line shows the hypothetical growth in intrinsic value of a company in a steady economic sector such as consumer staples. The pink line shows the stock market's evaluation of the company's shares. Note that sometimes the market in its enthusiasm pushes the stock price way above the company's intrinsic value. At other times, the market pummels the price way below intrinsic value.

Ideally, we strive to buy at a good discount from intrinsic value, such as in year 8 when the intrinsic value is $15 per share compared to a

market value of $10, a 33% discount. By year 11 the stock price has moved to $19, a modest overvalued status. If we sold there, the return over three years would be a very satisfactory 23.8% per year. But notice the stock price did nothing from year 8 to year 9. In hindsight (which is always 20/20) even better returns would have been achieved had we waited a year. Buying at $10 in year 9 and selling at $19 would have resulted in 37.8% compounded returns. So investing too early can test investors' patience, but if we are correct about the level and trend of intrinsic value, the investment returns should still be quite respectable.

The graph illustrates another point. Even a great company, such as our hypothetical consumer staples example, can prove a disappointing investment if purchased at the wrong price. We subscribe to the adage "Price is what you pay. Value is what you get." For instance, an investor who bought the stock in year 3 at $16 per share (about 40% above intrinsic value) would have had one good year and then a string of poor returns. If he stubbornly held on until year 11 he could have sold at a $3 per share gain. Because he failed to evaluate the intrinsic value and paid too much for a good company, his compounded 8 years return would have been only 2.2%.

We can summarize the keys to good value investing as 1) get the intrinsic value right and 2) buy at a sufficient discount from intrinsic value to provide a margin of safety. In the real world, of course, investors will not always get the intrinsic value right. In those cases they must recognize their error, sell, and move on to better opportunities. Sometimes investors are correct about the intrinsic value but are a bit early in buying. We think investing clients in a reasonable number of companies whose stocks are undervalued should enable us to overcome our occasional errors in assessing intrinsic value or timing purchases.

Portfolio Challenges

Even with a sound selection of undervalued stocks, investors still face challenges at the portfolio level. What evidence is there that value investing will do better than just indexing to "the market"? What evidence is there that a portfolio of value stocks will perform better in the long run than one of "growth" stocks?

For the first question, we turn to the invaluable Ibbotson Associates Stocks, Bonds, Bills, and Inflation to analyze the performance of value stocks compared to the S&P 500, our benchmark for "the market." Ibbotson Associates drew its value universe from all stocks on the NYSE, AMEX, and NASDAQ with the exception of American Depository Receipts (ADR's), Real Estate Investment Trusts (REIT's), and Closed-End Funds. Their data begin in 1969. We won't delve into the details of Ibbotson's classification methodology for value and growth stocks except to say it is well accepted by academics and investment professionals. Table 1 shows the compounded annual returns for value stocks versus the S&P 500 by decade:

Table 1
Comparative Compound Returns

	Value Stocks	S&P 500	Difference
1970's	8.8%	5.9%	2.9%
1980's	18.4%	17.6%	0.8%
1990's	15.6%	18.2%	(2.6%)
2000's*	3.3%	(2.3%)	5.6%

*2000 thru 2004

Value stocks beat the market in every decade except the 1990's. The wildly speculative technology/telecom bubble of the late 1990's, which probably was a once in a lifetime anomaly, accounted for value's underperformance during the decade. Table 2 shows this in more detail:

Table 2
Value Stocks During the Mania

	Value Stocks	S&P 500	Difference
1995	37.7%	37.4%	0.3%
1996	22.6%	23.1%	(0.5%)
1997	33.8%	33.4%	0.4%
1998	12.9%	28.6%	(15.7%)
1999	11.8%	21.0%	(9.2%)

In the early stages of the stock market mania (1995-1997) value stocks maintained a historically narrow, but still positive cumulative advantage. The years 1998-1999, however, were very difficult ones for value managers and their clients, as we painfully remember.

Many pundits proclaimed a "New Era" in which the old metrics favored by value investors such as the price-to-earnings ratio, the market-to-book value ratio, and the dividend yield were dismissed as irrelevant to successful investing. The next three years proved how wrong those critics were as the S&P 500 declined over 43% compared to just 23% for the value stocks. That performance reflected value stocks' tendency to decline less in bear markets, thus acting more defensively to preserve wealth. Since 1969 the S&P 500 has suffered nine down years and value stocks outperformed in seven of them, or nearly 80% of the time.

Earlier we mentioned that some portfolio managers blend in growth stocks in an attempt to avoid the "style" underperformance that value investing endured during the late 1990's. Turning again to the Ibbotson data, we can see that the long term odds are stacked against that strategy because value dominates growth even more than it does the S&P 500. So an investor would have to exhibit exceptional timing to know when blending in growth stocks would improve returns. See Table 3.

Table 3
Comparative Compound Returns

	Value Stocks	Growth Stocks	Difference
1970's	8.8%	3.2%	5.6%
1980's	18.4%	15.3%	3.1%
1990's	15.6%	20.0%	(4.4%)
2000's*	3.3%	(7.3%)	10.6%

*2000 thru 2004

In the 36 years from 1969 to 2004, value stocks outperformed growth stocks in 23 years or about 64% of the time. So we would say the probabilities favor value investing over growth investing, not in every year, but in the long run. We believe there are deep-seated behavioral reasons why investors tend to pay too much for anticipated future growth while ignoring the investment potential of out-of-favor or boring stocks. But that is a topic for another time.

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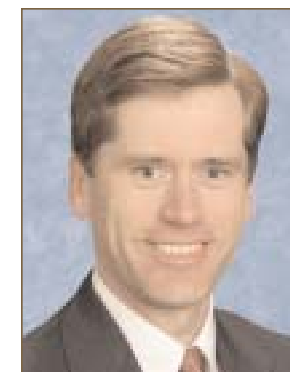
Intrinsic Value



by John Healy
Patton Albertson & Miller, LLC

"What's the business worth?" This is the first question we always ask ourselves when researching a stock. In the 1930's, Ben Graham recommended that investors spend time and effort analyzing financial statements to determine the underlying value of companies. His legendary protégé, Warren Buffett, took this advice to heart, later stating that the concept of intrinsic value "offers the *only* logical approach to evaluating the relative attractiveness of investments and businesses."[1]

Despite the success of Graham and Buffett, and the success other adherents, not everyone agrees. Perhaps this is because, when you start calculating intrinsic values, you find yourself thinking in unconventional ways. For some reason, people have a tendency to reject the unconventional simply because it's unconventional, particularly when following the crowd has paid off.

But with the crowd, there's no evaluation. You merely float down the river, slowly in the calm waters and quickly in the rapids, but never with an ear for the waterfall, and always without a paddle. In this analogy, calculating intrinsic value is like having a paddle. You're able to go faster in calm waters, position yourself more safely through the rapids, and get to the bank if you hear the roar.

So how do you calculate intrinsic value? It's the present value of an investment's future cash flows - simple to understand, but often difficult to compute. The difficulty is another reason why not everyone uses it. It's not an exact figure. It can only be estimated, which leaves it open to mishandling. Having a paddle doesn't guarantee that you'll steer clear of the rocks.

For instance, works of fine art are notoriously difficult to value because no cash is received until the artwork is sold. Any inherent benefits accrued to the owner can't be measured in dollars. Beauty and inspiration can only be measured when ownership changes hands at a freely-determined price. In this case, the

continues...

Subtle Shift at the Fed

by Charlie McAnally
Patton Albertson & Miller, LLC

As expected, the Federal Reserve's Federal Open Market Committee left rates unchanged at the conclusion of its two day meeting on March 21. Also, not surprising, the FOMC acknowledged in its policy statement that "recent (economic) indicators have been mixed (in the last statement they referred to growth as "firm") and the adjustment in the housing sector is ongoing". What was note worthy, however, was what was left out of its policy statement. It dropped the reference used in its five previous statements beginning last August to "additional firming (meaning a rate increase) that may be needed to address" inflation risks. Some analysts and market participants thought the deletion of the "additional firming" language signaled that the Fed is no longer predisposed to raising rates and was opening the door to a rate cut later in the year. Accordingly, stocks rallied and interest rates declined.

Almost overlooked in the policy statement at least for a day or so was the comment that recent readings on core inflation "have been somewhat elevated" and that the "predominant policy concern remains the risk that inflation will fail to moderate as expected." After several days of reflection, Wall Street economists were divided over what message the Fed was sending. For instance, Merrill Lynch and Goldman Sachs predict three rate cuts this year, Bear Stearns predicts two increases and Credit Suisse predicts no changes. David Wyss, the chief economist at Standard and Poor's, perhaps summed up the source of the confusion with his statement that "Anything they say is going to confuse people for the simple purpose that people want the statement to tell them what the Fed is going to do next, and the Fed doesn't want to say".

Perhaps it is fair to say that the Fed itself doesn't know what it is going to do next. A week after the FOMC meeting, Bernanke testified on the economic outlook before the Congressional Joint Economic Committee. He tried to clarify the FOMC's statement by saying that the FOMC had not shifted its policy bias away from controlling inflation but that "uncertainties around the outlook have increased somewhat in recent weeks" and that the statement was designed to give the FOMC slightly "more flexibility" depending on the outlook for both inflation and economic growth. At the JEC, Bernanke said "to date, incoming data have supported the view that the current stance of policy is likely to foster sustainable growth and a gradual ebbing in core inflation". In February, Bernanke testified to Congress in the Semiannual Monetary Policy Report that the Fed expected real GDP grow between 2.5% to 3% in 2007 and for inflation, as measured by the PCE price index excluding food and energy, to range between 2.0% and 2.25%.

However, he pointed out that there were several reasons why economic growth might not be as strong as forecasted. The obvious culprit might be that the housing market is influenced more severely by problems in the subprime market than they currently expect.

He also pointed out that the recent weakness in business spending, which had been weaker than anticipated, could be "an additional downside risk" if the weakness persisted.

On the other hand, he pointed out that there were "upside" risks to the Fed's expectation that core inflation will moderate over time. Indeed, the latest reading on a year over year basis was 2.4%, higher than their 2007 forecast and higher than the long term target of 1% to 2% favored by most of the FOMC members. Several risks mentioned by Bernanke were the tightness in the labor markets, energy, and other commodities.

In summary, the Fed is potentially facing an unattractive situation whereby economic growth is anemic and inflation picks up. Some pundits have even wondered if the country is facing a period of "stagflation" such as was experienced in the late 1970's. At this point, most analysts would probably agree that such characterization is too harsh.

In the meantime, with the Fed's next move uncertain, market participants will be scrutinizing the economic data even more carefully. ■