NEW ERA VALUE INVESTING

A Disciplined Approach to Buying Value and Growth Stocks

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PREFACE

Most books on equities investing are written during the advanced stages of bull markets when the public's interest in the subject is peaking. This book was written almost two and a half years into a wrenching bear market by a portfolio manager whose investment performance has not been particularly good in this exceptionally challenging market environment. This begs two questions: Why now? Why me?

The answer to the first query is easy. As a died-in-the-wool value investor, I believe in buying cheap and selling dear. Relatively few stocks are truly cheap during the latter stages of a bull market, whereas there are plenty of great fundamental bargains toward the end of a bear market. Bear markets are a perfect time for investors to pick off great companies at low valuations. What better time to introduce a value-driven investment discipline to investors?

The answer to the second query is a little trickier. I've spent my entire seventeen-year career as a value manager for large companies, municipalities, mutual funds, and individual investors. My quest for value has resulted in a focus on discipline both from a valuation and fundamental research standpoint. The Relative Price-to-Sales Ratio (RPSR) strategy detailed in this book has not been especially effective over the last eighteen months. Is this a cause for concern? We think not. The most important thing when employing a discipline is consistent implementation. RPSR has identified cheap high-quality companies, and the market will eventually follow. The discipline works because the market cycles; if investors remain constant it will come back our way. Relative Dividend Yield (RDY), our original valuation discipline, has produced results over the long term but has struggled during periods when growth investing ruled. But, by their very long-term nature, both strategies will identify stocks that will not outperform each and every year. However, they will outperform over the long term, which should be the time horizon of most investors. The disciplines this book will discuss have produced excellent long-term track records, which I believe will help readers target the stocks that will produce the most generous returns in the years ahead.

There has been a long-running debate on whether growth-at-a-reasonable-price methodologies such as mine qualify as value investing. This debate has intensified over the last year, as traditional value portfolios have outperformed and value-oriented growth stock investing has underperformed. Indeed, "absolute value" investors, with low price/earnings ratio portfolios concentrated in the most defensive market sectors, have had considerably more success than anyone else as the stock market has plummeted over the last few years, which is how it should be. I believe in traditional value stocks and hold some in my portfolios, but with the flexibility of the discipline this book will be introducing to you, I am able to identify stocks that trade at value-investor valuations, with growth-investor earnings potential. Coming out of a bear market, this is where investors want to be. Over the long term, I believe buying industry "Cadillacs" when the dealer (the market) is offering big incentives is a better definition of value than buying more cheaply priced, but much slower and poorer quality "Yugos." Put another way, "cheap" is not a synonym for "good value."

Warren Buffett, the most famous value investor of our time, is what I would call a growth-at-a-reasonable-price investor. Mr. Buffett has earned his well-deserved reputation as a connoisseur of value by buying high-quality growth companies when they are experiencing temporary difficulties or, for whatever reason, have lost favor in the market. Although over the short term, Mr. Buffett's portfolio of "fallen angel" growth stocks has periodically underperformed, over the long term they have made Berkshire Hathaway (Buffett's holding company) shareholders an enormous amount of money.

As I write (October, 2002), the Dow Jones Industrials and S&P 500 are at four-year lows and the NASDAQ Composite is off almost 77 percent from its March 2000 peak. Naturally, some commentary about this wrenching bear market is in order. At this stage, I think the most important thing to understand is that as investors approach bull market peaks and bear market bottoms, they develop an almost total disregard for fundamentals. Back in late 1999 and early 2000, investors didn't care about P/E ratios. They simply wanted to buy stocks because they were going up. Wall Street was bending over backwards to justify sky-high valuations and their nearly unanimous buy recommendations. Today, investors are equally oblivious to fundamentals. The S&P 500 is trading at about fifteen times next year's earnings estimates—near its historical P/E average and lower than one might expect given today's historically low bond yields and inflation, as well as improving economic and earnings trends. But investors seem to be ignoring the improvements, waiting for what they call visibility. This reflects doubt that earnings will be as good as anticipated.

Normally, low bond yields combined with relatively good economic and corporate earnings news would buoy the stock market. But not this time. The financial press and politicians gearing up for mid-term elections are placing most of the blame for the market's dismal performance this summer on the "crisis in confidence" spawned by accounting scandals and corporate malfeasance. This makes good copy and provides politicians airtime and ammunition to use against their opponents in the upcoming elections. However, the turmoil and volatility is likely to continue for some time. For times like these, the valuation disciplines are made to order.

In my view, one of the benefits of this bear market is that it has seasoned a whole generation of investors. Healthy fear and respect of the bear is a good thing and will result in prudent, intelligent investors. In our family of mutual funds, Fremont

Funds, individual investors have been doing exactly what they should be doing: averaging into a diversified portfolio of funds. Outflows have been modest.

I wrote this book because I believe passionately in the virtues of *discipline* in investing. If you find our valuation discipline of interest—great! If not, find a discipline that appeals to your appetite for risk and your long-term return objective. But whatever your investing profile, be disciplined. A consistently applied discipline will ensure success. I will leave you with two of my own experiences that illustrate why discipline is so important. The stories have been told before, to Allen Clarke for his book *Adventures in Investing*, but bear repeating because they illustrate the importance of investment discipline so perfectly.

> *Best Investment*: In the spring of 1999, Oracle Corporation became attractive on a valuation basis. According to the way we look at the world, the stock had rarely been cheaper. The market was discounting slowing growth in application software. But Oracle was focused on Internet computing and the trend away from personal computers to servers. Oracle's commitment was articulated best by founder and CEO Larry Ellison, who believed that the best way to demonstrate the value of the Internet to Oracle's customers was to become an Internet-centric company centered around their own products—a brilliant move that served not only to lower the company's operating expenses but also to stimulate demand for new Internet applications. Oracle proceeded to beat estimates and "wow" the Street. Of equal importance to us was the quality of management and the fact that Larry was "engaged" in the company once again. Using the Larry Ellison indicator has proven to be a successful way to buy the stock—it performs better when he is in charge and not so well when he is sailing around the world in his yacht. The results? We realized about a 600 percent return from our acquisition price.[1]

Oracle is a classic example of how RPSR can be used to profitably invest in value-oriented growth stocks.

Worst Investment: Ignoring one of my long-held tenets of never taking stock tips from friends, I did something worse: I took a stock tip from a stranger of sorts. He wasn't a strange stranger; after all, I met him in first-class on a cross-country flight. He was CFO of a company that was in the midst of an IPO road show. We didn't talk about the deal, but we did talk. And after the IPO I would watch the stock from time to time. It took off and produced exponential returns for the investment bankers and early investors. After about six months the stock pulled back about 50% and I jumped in, breaking all my own rules. I knew nothing about the fundamentals of the company beyond what business they were in and I knew nothing of the management except that the CFO was a very funny guy. I bought 200 shares of Smartalk Services (SMTK) for each of my kids' college accounts. "A little speculative growth can't hurt," I told myself. I purchased the stock at around $16 per share after an earnings disappointment. The first warning is rarely the last. The stock was eventually delisted and the company filed for bankruptcy. When I can get a value for my shares it shows a price of pennies per share.

I did just about everything wrong in that transaction, but the most critical error was buying stock in a company I knew nothing about. I didn't follow my discipline and I *gambled* with my hard-earned money. Although I will never salvage the loss, the shares remain in the account as a painful reminder of my error.[1]

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NOTE

1. Allen Clarke, *Allen Clarke's ADVENTURES IN INVESTING*, *How to Create Wealth and Keep It* (Key Porter Books Limited 2000).

ACKNOWLEDGMENTS

The acknowledgements section of a book always reminds me of 8th grade graduation. The part where the principal stands up and tells the graduates that they will be sorely missed since "you are the best class to ever pass through these halls." Yeah, right.

The traditional *thanks to all who dedicated so much of their time to this manuscript* falls flat. I would like to raise the bar for all future authors who drain the time and intellect of so many to achieve so little.

First and foremost I want to thank the founding fathers of this great country for one of the most successful experiments in free trade and capitalism ever ventured. To all the investors who every day take their hard-earned money and invest in the future of this country and their own retirement while fighting the hangovers of insider trading and corporate accounting fraud and terrorist attacks and economic slowdown, you are the real heroes of capitalism—you have my enduring respect.

In the development of this tutorial on our approach to "skinning the cat" I would like to thank the beyond-the-call-of-duty efforts of Bill Fergusson and Michelle Swager of Fremont Investment Advisors. In addition to the creative demands and deadlines of running the marketing activities for a mutual fund complex, Bill and Michelle devoted hours of their personal time to fact-checking and editing this book. They made strategic contributions and added to the overall interest and editorial content of what you are about to read. In her spare time Michelle got married and Bill went to Fiji.

Steve Kindell assisted in developing much of the content in the book. Steve is an incredibly bright and lively contributor. After this mundane project, I recommend that Steve write the definitive history of the world—if anyone can do it, he can. His seemingly endless knowledge and turn of a phrase was a great help and was sincerely admired.

The analytical team at FIA should be awarded hazard pay for devoting enormous effort to navigating through a bear market and then having the annoyingly pesky task of responding to my requests for data . . . and more data. Harshal Shah, Joe Cuenco and Matt Costello provided historical perspective for the companies they cover and important analytical insight—not to mention all of the charts!

Noel DeDora and I have worked together since 1984. It's been a load of fun and Noel continues to be the single smartest individual I have ever met. (He is also the perfect straight man.) Noel has contributed a lot to my view of the world and my education of the capital markets. His early adaptation of RPSR as a way to identify value outside the dividend paying pool of stocks we had fished in for so many years was revolutionary at the time. After thirty years in the business, he has seen it all and made a ton of money for our clients. When he does decide to leave behind the "old stock and bond place" as he calls it, he will be greatly missed indeed. Luckily the investment business doesn't require heavy lifting, and I am hopeful he will remain involved for decades to come.

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