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listeningin

Going Nowhere

Denver Money Manager Stalks Profits In “Range-Bound” Market

*If the enthusiasm Denver money manager and author **Vitaliy Katsenelson** (pictured on page 2) brings to his studies of the markets seems a bit, well, over-the-top, it's because he's a convert; a self-proclaimed “capitalist pig” whose childhood, in Murmansk, the Russian navy's Arctic Ocean port, was circumscribed by strict Communist orthodoxy in school and by his Jewish family's second-class status in society. Spared a stint in Russia's military by his family's immigration in 1990, when he was 18, Vitaliy proved himself a quick learner, picking up a B.S. and a Masters in finance at the University of Colorado, where he's now on the adjunct faculty, and snaring his first job in the investment business just four years after landing in America. What's clear in talking with Vitaliy is that his early experiences kindled in him a deep skepticism of dogma that pairs nicely with a restless intellect in his explorations of markets. Questions, he asks, fresh perspectives, he brings, and insights emerge. Now director of research and a portfolio manager at Denver-based **Investment Management Associates**, an institutional boutique with about \$80 million under*



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management, Vitaliy last year published, **“Active Value Investing, Making Money In Range-Bound Markets,”** after coming to the conclusion that stocks for the long run had become a recipe for ruin. When we chatted last week, Vitaliy brought me up to date on why he thinks this is neither bull nor bear – and what he's doing about it. Read on, even on the beach.
KMW

Despite oodles of volatility at times, the stock market has essentially gone nowhere for the last decade, which, I take it, was the inspiration for your book – or

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Christopher Weyant

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maybe the source of frustration that spurred your research?

That's right. While what I tend to talk most about today is fairly macro stuff, that's not how I first came to this study. What happened was that I realized, back in '03 or maybe '04, that historically, stock markets did have secular cycles. At first, I didn't understand why and was sort of shocked to find them; my training and background are in fundamental analysis and I tend to be skeptical of technical analysis. But when I looked at charts of, first, the last 100 years, and then of the last 200 years, what I saw was that every time you had a full-blown bull market, it was followed by a market that didn't go anywhere, just got caught in a trading range, moving up and down but going nowhere. That intrigued me, so I started to look into why it happened. At first, I thought maybe it's just that the economy grew faster and then grew

slower, etc. But as soon as I started to study the data, I realized, my God, these cycles do make a lot of sense, and historically, they had very little to do with the economy; they were really all about compression of valuations. And as I did more research, I realized that the way I had invested in the past was *not* going to work well in this market, because I was trained to invest in a bull market, and a range-bound market is a very different animal.

You go to great lengths to avoid calling this a bear market – why not call a spade a spade?

I think its big mistake to call this a “bear market” because that implies to most people that the market declines markedly over a period of time. If you asked me to point to a secular bear market, I would say to look at what happened in Japan from the late '80's to 2003 - 2004.

That's what a secular bear market looks like, to my mind, an 80% decline, or whatever that

number was, over a 13 -15-year period. Those are very rare. More typically, bull markets have been followed by long stretches in which the market fluctuates without going anywhere. To me, it's not a bear market, it's a sideways market. The net effect is that you are making a lot less money than you would have made in a bull

market, but you are not necessarily losing money.

If, I take it, you're fleet of foot enough to stay on the right sides of the market as it fluctuates in that range. Which is easier said than done.

That's right, but it's better than buying and holding. You can think about this as wiggles around a straight line; those are the little cyclical bull and bear markets that you have within a secular range-bound market. What I saw, when I looked at the data [see chart opposite] is that with bull markets typically being followed by below-average returns – in

range bound markets – of similar duration, buying and holding just isn't a strategy most humans can stick with over the “long run,” unless they get very lucky in timing their entrance. For example, investors who bought the DJIA in 1966 expecting to get the long-term average market return over a 15 or even 20 year horizon would have been terribly disappointed, as real returns turned out to be far below the expected average over during that long range-bound market. In fact, a broad market portfolio invested in 1966 would have received *no* real returns for 16 years, until the start of the next bull market in late 1982. It took the full market cycle of 34 years for investors who bought a broad market index in 1966 to get a 6.8% annual real rate of return. And the funny part is, the easiest way to explain why those things happen is to look at it as a math problem.

Funny to you, maybe.

Really. It's *simple* math. If you look at a stock or



stock market, you can explain mathematically the return you get from them with just two factors (ignoring dividends, for this example). It's really just a matter of P/E contraction or expansion and of earnings growth. Those are your two variables. In other words, if the P/E always stayed the same, say at 15 times, the return you would have gotten from price appreciation in the stock market over the last 100 years would have been about 6%, to which you would have added 3% or 4% from dividends.

Would that it were so easy.

It isn't. The market's price/earnings multiple going up and down is what is responsible for the difference in historical returns. When I looked, I saw what has happened. Bull markets historically started when the P/Es for stocks were much below average. Usually below 10. So during the bull market, the P/E went from below average to above average. In other words, the multiple expansions added to the 6% return you roughly got from earnings growth, and produced bull market returns. By contrast, range-bound markets take place after the bull markets, starting when P/Es are *very* high. As those multiples decline, they basically produce negative returns that subtract from earnings growth, so you get zero, or slightly minus, returns from stock price "appreciation," in addition to whatever dividends add to your returns.

You say "to-ma-toe" and I say "to-ma-ta;" You say "range-bound" and I say, "bear market."

Again, I'm using range-bound to differentiate between markets like this one and a secular bear, which I think requires not just very high valuations at its start, but a horrible economy that remains horrible for a long time. Japan not only had very high valuations in the late '80's, its economy fell into deflation, producing that 80% or whatever market decline over the next 13 years.

So Japan's malaise and the Great Depression here are the only experiences you'd really call secular bears?

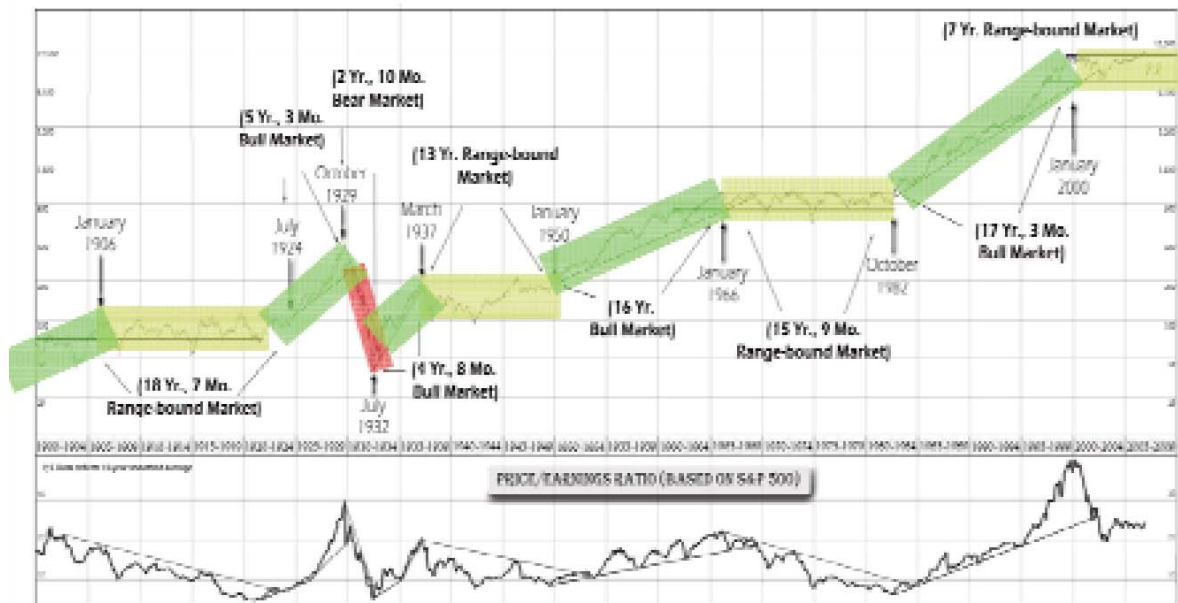
Yes, though actually, because the Great Depression lasted less than five years, it doesn't truly fit into my strict definition of a secular bear. I put it in the secular bear category anyway, because some 70 years later, we're still talking about it as the "Great Depression."

Okay, but your real interest in getting into all this wasn't nomenclature, it was how to make money as a long in a market that isn't behaving like a bull?

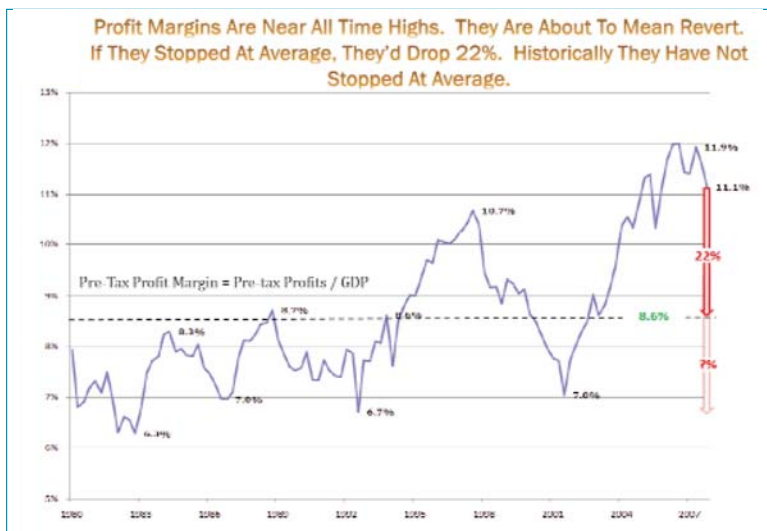
Exactly, I started researching my book basically to come up with an investment strategy for me and for my firm – to survive and prosper in this range-bound environment. That turned into

"Typically, bull markets have been followed by long stretches in which the market fluctuates without going anywhere. To me, it's not a bear market, it's a sideways market."

The "bear" markets were actually **range-bound** markets and happened **1/2** the time



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“Active Value Investing.”

Why restrict yourself to a long-only strategy?

Basically, because we can't short for our accounts, which are mostly smaller institutions and high-net worth individuals in separate managed accounts. But even if we could, we don't like the risk/reward inherent in shorting.

Okay, but being an “active” value investor almost sounds like an oxymoron –

That's a misconception. I'm not suggesting that anyone becomes a day trader, if that's what you mean. It comes back to this: In this environment, you want to become a buy-and-sell investor. This is unlike a bull market, when a new religion is born, called the buy-and-hold religion. I know, it's a great religion, with a lot of great members. Even **Warren Buffett** is often considered a buy-and-hold investor. So why shouldn't you be, as well? The problem is that while buy-and-hold works great in a secular bull market, when P/Es are expanding from below-average to much-above-average, it doesn't work at all in a range-bound market, when P/Es contract. That is something I learned the hard way. Every time you make a hold decision, which really is a not-to-sell decision, in a bull market, it's rewarded by higher P/E. So almost like Pavlov's dog, you are trained not to sell, because you're a “long-term investor,” and because Warren Buffett is a “long-term investor.” By contrast, every time you make a hold decision in *this* environment, when P/Es are *contracting*, you stand to take a hit.

Simply because the tide is going out?

Right. Even if you own fairly valued stocks, the multiples on those stocks decline in the long run. So you have to be a buy-and-sell investor. You have to figure out how much a company is worth; you buy it only with a great margin of safety, and when it goes to fair value, you sell it and look for another company to buy. You simply can't rely on a favorable tailwind of generally rising multiples to drive its valuation ever-higher. Which means that if I buy a stock at basically 50 cents on the dollar, expecting a 50%-100% return over a 3-5 year period, and I get lucky enough to see it appreciate 50% the next day (it *could* happen, though I've never been that lucky), I should sell it. You may call that a “trade,” or you may look at that as a low risk investment that just got lucky. Of course, being active in this way will increase your turnover, absolutely. You're not going to be holding most stocks for 10 or 20 years. Remember, your return from holding a stock comes from just three sources: earnings growth, P/E expansion, and dividends, and historically, value investors have gotten most of their returns from multiple expansions. So if you get lucky and capture most of the expected return from the P/E going from low to fair value overnight, grab it. Sell that stock and buy another with a higher expected return. After all, any more return on that lucky stock would depend on growth in earnings and dividends – and *maybe* you have a portfolio full of young Microsofts that can grow earnings 25% a year for the next 20 years, but statistically, there's a very small chance of that.

Besides, you can be pretty certain that even if that “lucky” stock turns out to be a great long-term holding, Mr. Market will go into a funk at some point and offer it to you at another attractive entry point?

Exactly. That's why the process that we go through here, and that I suggest in my book, starts with identifying great companies. We figure out roughly what these companies are worth, and figure out how much margin of safety we need, and that gives us a rough buy price on the stock. Then it's just a matter of time before we get opportunities to buy what we want at our prices.

Isn't what you're really doing just plain old market timing?

No. Although, as I said, a range-bound market is made up of lots of little bull and bear market cycles, we're not trying to be *market* timers – basically because I don't know of anyone who

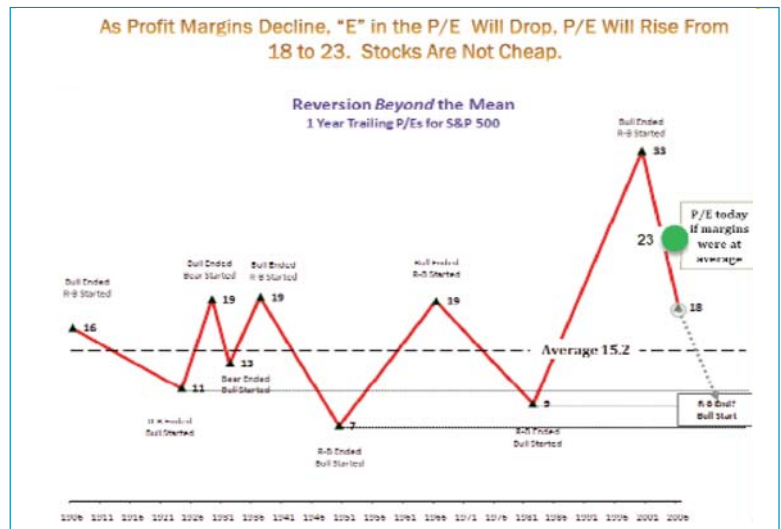
has devised a market timing tool that works consistently over time. But what we *are* timing, as value investors – though we don't tend to think of it this way – is *stocks*. We are really stock timers. We buy them when they're undervalued, or at least, we should, and sell them when they're fairly valued. We just have to do the selling part more consciously, or more actively, in a range bound market. And do it over and over again. Actually, as it turns out, this is also a strategy, or investment framework, that will do well in virtually any kind of a market environment.

Vitaliy, a lot of investors contend that multiples are already quite reasonable today – where is the contraction you're talking about coming from?

That's the second thing that I kind of discovered while looking at all the data I collected, which is that profit margins also contract in a range-bound market. I've since written three articles about it. The first appeared in *Barron's [Other Voices, 2/4/08]*. What I realized is that when you look at the stock market today, it doesn't *look* that expensive, trading at around 18 times trailing earnings. That doesn't *seem* too bad, if the long-term average is 15. But there are a couple of problems with that. First of all, to get to that average valuation implies that the stock market historically went from trading at one extreme to the other. So if the average was 15, the high was probably 20, and the low was probably 10. The other problem is that the market is only trading at 18 times earnings if you don't *normalize* earnings.

Bingo.

When you normalize earnings, then the market's current valuation is a lot higher. And, you *have* to normalize earnings because profit margins are the most mean-reverting creatures in finance, if I can quote **Jeremy Grantham**. Simply because that's how capitalism works. Well, after that piece was published, I got a lot of emails asking me where, in what stocks, did I see excess margins. So I did a little more research using the only data on sectors that I could find, which covered the 1988-2006 period. What I found was that the excess margins at yearend 2006 were concentrated in, really, three big groups of stocks. The No. 1 group was the financials. The financials had very high profit margins. Those margins were already deflating *very* fast, but they were responsible for about 20% of the excess margins in the whole market, as of yearend 2006. The financial



sector's margins, at the point, were at a 20-plus-year high. From 1988 to 2006, they had averaged about 8.6%, but in 2006, the sector's profit margin was at 11.9%. More than three points above average. But of course, those profit margins, as we know, have already been wiped out by losses.

Or those once-reported profits were illusory.

Exactly. Again, what people forget is that profit margins don't just drop from high to average. But if profit margins *did* fall and stop just when they reached the average level – instead of overshooting as they have historically – the market's P/E would rise from 18 to 22. And now the banks that were reporting big profits are reporting big losses. Then, the second group where I found that profit margins were excessive—and this is the biggest group, responsible for 55% of the excess—is made up of what I call the “stuff stocks.” It includes basically three sectors: energy, materials and industrials. Finally, I also found excess margins in what I call the “new economy stocks,” basically, information technology and telecom. They were responsible for 15-16% of the excess.

So you're saying tech stocks are also vulnerable to margin contraction?

Not necessarily. My argument there is that their profit margins are high, but maybe they *should* be high because the benchmark has changed. I'll explain what I mean.

Good idea.

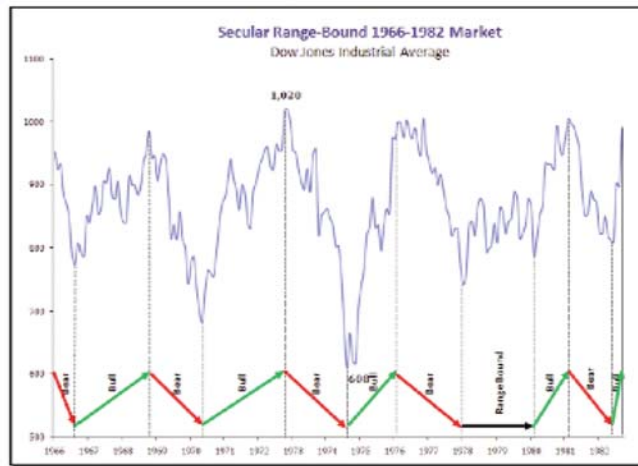
In 1988, **IBM** was probably responsible for a huge portion of the information technology sector, and at the time, it was making a lot of hardware, a little bit

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Secular Range-bound Market: Is Comprised Of Many Cyclical Markets



of software, a little bit of services. Today, by contrast, IBM is a software company that has services and also makes a little bit of hardware. Likewise, Microsoft, in 1988, was almost still in its infancy. Now, it's a much different company. My point is, the composition of the sector has changed; it's much more tilted toward higher margined software and services. So could the margins decline? Absolutely. But should they decline to below the 1988-2006 average? They probably don't have to decline *as much* as the financials and the stuff stocks, because maybe the mean has shifted.

You do expect, though, profit margins to decline for the stuff stocks? We've already seen moves in that direction.

Yes, I wrote about this in a piece that the *Financial Times* published last May 3 [*Look To The Margins When Using The P/E ratio*], exploring what it would take for the stuff stocks' margins to decline. What I realized was that if you look at stuff companies like **Caterpillar, Deere, Paccar**, they all have one thing in common: a very high degree of operational leverage. When the global economy is growing at a very fast rate, their costs don't grow as fast, so their margins expand. But when the global economy slows down, that operational leverage starts working against them. The thing is, these are just not the types of industries that can maintain fat margins. The funny part of this is, everyone used to look at these industries as being boring cyclicals, and now they're considered "growth" stocks, just because they have behaved as growth stocks here: Their P/Es have expanded, margins have expanded, sales have grown at a very past pace.

Something changed –

Right. Even though, historically, the stuff stocks' growth was cyclically tied to the U.S. economy, this time around, they kept growing, even as the economy slowed down. What is interesting is that the *reason* they kept growing was that China and India kept growing, very fast – and China and India and some other emerging countries consume a lot of stuff. But as China slows down, and as India slows down, and as the rest of the world slows down – that is when the sales of the companies in the stuff sector will just crater.

The emerging markets slow down? That was heresy until rather recently. They'd decoupled, remember?

It's a nice theory, but – the problem is, it doesn't wash with reality. China is where it all gets very interesting.

I doubt you're referring to the Olympics. So, how so?

The reason our economy was growing since early 2000 was because we were borrowing money, in the sense that we probably would have had negative GDP growth, if we weren't borrowing money through home equity loans, etc. And on a macro level, China and India basically were financing that as they invested their ballooning foreign currency reserves in treasuries.

Right. The emerging world was supporting our consumerist spending binge.

The funny part is, they were giving us money and now we, essentially, are holding that money hostage. But getting back to the emerging markets, our over-consumption was what had them growing at such a blistering rate. We basically should have had a recession years ago, but we didn't, because our very low interest rates kept the housing market booming. But now our long-delayed recession is likely going to come (if it isn't already here) and it's probably going to last a lot longer than most people expect.

What makes you suspect that?

Just because it's a consumer-driven recession and consumers are two-thirds of the economy. That says to me that there's a good possibility of it lasting longer than previous recessions that were mostly industrial, or corporate recessions. Those typically started with overcapacity, too much inventory. Then companies laid off people, cut inventory, unemployment went up, and companies started to hire people again, growing the economy out of the recession. This time

around, everything looks likely to make this recession last longer. The excess in the economy – which is debt – is concentrated in the consumer sector, so our consumption of everything will likely slow down. Which will impact a lot of things, including China. Our consumption of Chinese goods likely will slow down. European consumption of Chinese goods likely also will slow down.

The counter-argument is that China's own domestic demand is more than capable of taking up any slack.

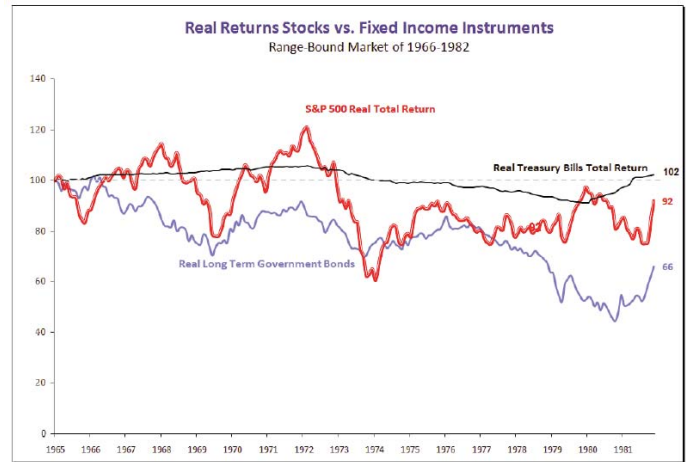
The problem I have with the suggestion that China's middle class will consume China – much less the globe – out of this slowdown, even though it might make sense on the surface, is that high commodity prices actually impact China disproportionately more than they impact us. The example I use is a loaf of bread. The cost of the wheat that goes into a loaf is more or less the same in China and in the U.S. But the labor component is a lot higher number in the United States than it is in China, almost by definition. So if global wheat prices go up, the impact of the higher wheat price on the price of bread is going to be a lot greater in China than in the United States, just because commodities costs are a larger component of the total costs. What's more, the impact there is even worse, because in the developing world a much greater proportion of income is spent on food than in the U.S. They spend almost two times more than we do on food, as a proportion of their incomes. Therefore, increasing commodities prices disproportionately impact Chinese consumers, who have a lot less discretionary income left – at the same time they are battling high inflation. So it's very unlikely that Chinese consumers will be able to bail out the Chinese economy, much less ours. Their growth will slow down. Another analogy I like to make is that China is like the bus in that movie *Speed*, with **Keanu Reeves** and **Dennis Hopper**.

This, I have to hear.

Hopper is the bad guy who wires the bus with explosives. If the bus slows down below 50 miles an hour, it blows up. The analogy is that China has grown so fast for so long that the economy is wired to grow at fast rates. So when growth slows down, that slower growth will “blow up” the economy. By which I mean, send it into a severe recession.

You've also recently compared China with Starbucks (SBUX). What's that all about?

Range-Bound Markets: Stocks Dominance Is Not Significant



I'm drinking Starbucks coffee as we talk, so you know I think it is a case of a good company but not a good stock. At least at this point. I'd love to own Starbucks – at a lower price. I've compared it with China because Starbucks' problems are so transparent to us now, in hindsight: When you open five new stores a day, you're going to make some bad decisions. There are physical limitations. How much prime real estate can you lay your hands on? If your goal is to grow that fast, you're going to sacrifice your own standards. You're going to open stores on the wrong side of the street, too close to each other; you're going to make marginal hiring decisions, you're going to hire baristas who are only qualified to work in *Burger King*. That's what happens when anything grows too fast. The quality of the growth, in the late stage, especially, becomes *very* low. But an analyst only tends to see it after the fact, because as long as it's growing, the company is still producing great numbers. It's only when things slow down that the impact of those inefficiencies comes to the surface. As Warren Buffett says, when the tide goes out, you start seeing who was swimming naked. I think that is going on in China. When an economy of that size is growing at 10% a year for 10 years, the quality of its recent growth is not likely to be very high, especially if you throw into the mix the fact that politically, it's still a Communist country, with a lot of corruption, a lot of cronyism.

No argument, it's a queer mix of a repressive dictatorship and a pseudo-capitalist command economy. But anyone who saw the opening ceremony of the Olympics

knows they can do some amazing things.

The opening ceremony was the most incredible thing I'd ever seen in my life. But consider that they had many years and virtually unlimited resources to devote to creating that spectacle. We'll never know how many billions of dollars they spent to demonstrate their national pride. But we do know it far more than any other national economy could rationally afford to budget. My point about China's growth rate is simply this, when anything grows at that pace, mistakes are going to be made. Buildings will be built that aren't up to code; bridges will be built to nowhere.

Are you talking about China or the U.S. Congress?

Let's just deal with China's "growth miracle" here. As a skeptical investor, you have to ask what could go wrong. When it comes to China, the answer is plenty. What got me thinking about this the other day was an article about the biggest shopping mall in the world. It is the South China Mall in Dongguan, a factory city in the Pearl River Delta, and it's empty. The mall was built to hold 1,500 stores, but only a dozen stores are open. Talk about bad capital allocation and inefficiency! Unfortunately, as I said, we only recognize inefficiency after the fact. During the booming bull market, when financial stocks were analyzed, all anyone saw were the rewards, not the risks. The risks are hidden when the economy is expanding. When the growth falls down, defaults go up, and suddenly, incredible reward turns into incredible risk. Does any of this mean that China is going to collapse and be ruined forever? No. But it is certainly slowing down. Economies have recessions because that's a curative process. They rid the economies of excesses that grow in an expansion. When you grow fast, you generate a lot of excesses. So all I'm saying is that China's slowdown may last longer than many expect. And because China uses a lot of "stuff," we may see the prices of stuff, like energy and materials, decline a lot further than people rationally expect. Because we will have declining demand and increasing supply.

Nothing much mild about it?

No. My No. 1 reason is that China has a high degree of operational leverage, which really just comes with the territory when you are a manufacturing economy. We not only sent all of that manufacturing capacity from the U.S. to China, but all of the volatility that went with it. And No. 2, they also have high financial leverage. So

what happens when your sales slow down? You first try to stimulate sales by cutting prices, which can send you into a deflationary spiral when the competition responds, and you have price wars. What I suspect may happen is that China goes into a profitless growth recession. The economy may still be growing, albeit at slower rates, but its companies won't be making any profits.

Does that matter all that much? Don't forget, profits aren't the *only* goal, or even the first, necessarily, of Chinese companies.

From our perspective, it matters very much for us. First of all, demand for our exports will decline. More importantly, demand for *stuff* will decline disproportionately more – I'm talking here industrial materials and metals, not necessarily energy. That's because most stuff, whether it's a tool or a tractor, has a 20-30-year life. What's more, if you built factories expecting tractor demand to grow at 10% a year, and suddenly your growth is only 6%, you have 4% overcapacity. Except that it's not really 4%, it's more like 20% or 25% or 30%, because when you built the factory, you factored in very high growth for the next 5-10 years. Suddenly, you have huge overcapacity and you don't need to build more tractors. Now look at Beijing; at all the skyscrapers they have built. Think about all the steel and concrete they used to do it. If they're going to be building a lot fewer, they'll need *a lot* less of those building materials. So the demand for stuff, at least for industrial materials, will drop substantially – at the same time that high prices are also cooling demand for commodities.

I guess you're not long commodities?

That's right. As a portfolio manager who can't short, I think about the best way to beat the market over probably the next five years is to substantially underweight the stuff stocks. That is what we've done, basically. The only problem is that if you had done this the whole time for the last two or three years, you would be lagging the market by a lot, because those were the stocks that that pushed up the market during the latest rally cycle. We've compared what happened in them, to some degree, to the technology bubble. But I liked better what **James Montier** said when you interviewed him recently [*w@w*, 5/30/08]. He called it the "growth expectation bubble," and I think he characterized it perfectly. You had wrong expectations built into stocks and commodities in general, and that's where the bubble was, in expectations. That's why I think that **Jeremy Siegel's**

book [*Stocks for the Long Run*] – even though it’s a great book that I learned a lot from and have used a lot – actually probably did an enormous disservice to many investors, because it created an expectation that you’re going to make 11% year after year, or 7% real, in the long run – without getting them to focus on the fact that the long run is a lot longer than most people think.

Though you have to admit, he did try. “For the Long Run” is part of his title. And as another famous professor once said, “In the long run, we’re all dead.”

That’s right. But people prefer not to focus on that. They prefer to focus on the upside. They took confidence from the book that if they were playing for the long run, for 5 or 10 years, they could expect 7% real returns. But that’s not long enough. Because during boom markets, you get very high, above-average returns. Then, in a range-bound market, you get much below-average returns. That’s how the average is created. The range-bound markets are there to deflate the returns that you got in the bull market; that’s what they do.

So your entry price makes all the difference.

Exactly. That is where the active value investing strategy I describe in my book comes in. Just because this is a range-bound market, you don’t have to just throw up your hands and accept that you’re screwed. It may be optimistic of me, but I spent two-thirds of my book devising and implementing in real life a strategy to do better than the returns the market gives us in the long run during *this* environment.

So you don’t accept the notion that just because you don’t have the wind of steadily rising market indexes at your back in a directionless market, there aren’t opportunities for meaningful returns?

Exactly. But you have to make some attitude adjustments, in both your analysis and in your investment strategy. On the analytical side, you want to make sure that you don’t have a bull market attitude where you fall into relative valuation traps; that you don’t just say because a stock’s valuation today is lower than yesterday’s, it’s cheap. It may or may not be cheap. The company I use to illustrate this – because everyone knows it – is **Wal-Mart (WMT)**. Because Wal-Mart used to trade at 45 times earnings in ’99, when it got down to 25 times earnings, people started saying, “Hey, it’s cheap.”

“If you liked it at 45 times, you’ve got to love it at 25 times...”

Exactly. In hindsight, you *shouldn’t* have loved it at 45. What you really should care about is not what it used to trade at, but what it is worth. Instead of looking backwards, you have to look forward and focus on what is the company worth. That’s question No. 1. My second question is how much margin of safety do I need when I buy this company? My argument is that you need more margin of safety in a range-bound market because you want to overcompensate for the multiple and margin decompression. So, hypothetically, if in a bull market you required a 20% margin of safety, in this environment, you should demand 40% or 50%. When you do this, you make stock selection so much more difficult. But it’s worth the effort in a range-bound market.

Stock picking? It’s almost a lost art.

That’s because of the long bull market. There was some research, and it became a truism in the bull market, that 90% of the return on a portfolio comes from asset allocation. That is true in bull markets. You can throw money into stocks and your average stocks will do so much better than bonds or T-bills. But during a range-bound market, that’s not the case. You may not necessarily do better than bonds and T-bills just by owning average stocks. Historically, you haven’t. So the whole idea in a range-bound market is to own the best stocks possible—and a high margin of safety creates a best stock. The other key difference in a range-bound market is that cash is not trash.

Have you tried convincing many institutional committees of that?

I know, it’s hard. But this is so important. Yes, during boom markets, if you have cash, it is your biggest enemy because cash never rises as fast as the stocks do. It creates a drag in the portfolio. But in range-bound markets, cash is not your enemy, cash is your friend. If you’re looking for stocks to buy and you don’t see enough stocks that meet your criteria, you hold more cash, because the opportunity cost of holding cash overall is a lot lower, and it’s better than compromising your decisions. You only use up your cash when you see a lot of opportunities, and that increases the quality of your buy decisions.

How much cash are you sitting with?

We have felt the same pressure from clients to be fully invested, historically, as most portfolio managers, and it’s taken a lot of education about this environment – and actually sending

my book to clients – to get them comfortable with this, but we probably have 35% of our portfolio in cash. It was as high as 45% a couple of months ago.

Your book contains lots of detail and formulas for multiple methods of valuing stocks in a range-bound market. But what comes across most clearly is that you don't trust any of your valuation tools–
They all have to be combined with common sense.

A most uncommon trait –

That's right. The whole idea of including the nice little formulas – which are very simple, all you basically do is add and subtract, no higher math – was to help people understand the relationships better between quality and growth and value. And to look at them from different perspectives. The absolute P/E model in the book, for example, came out of a question my graduate students had put to me: How do you figure out the “correct” price-to-earnings for a company?” My first impulse was to give them the PEG ratio, price-to-earnings divided by growth. You know, companies growing 15% a year should trade at 15 times earnings. That superficially sounds great except what if the company is growing at 2% a year? Should it trade at 2 times earnings? So I developed my absolute P/E model, where a company that's not growing earnings still gets a multiple. **Ben Graham** used a P/E of 8.5, but I like round numbers, so I use 8. You can use any multiple you want, but it should have a P/E of more than 1. Then the question becomes, how much margin of safety you should ask for a stock?

More than in a bull market, I take it.

I thought about it a lot and realized that the margin of safety required for a stock is really a function of the company's quality, which I break down by looking at its business risk and financial risk, and of its growth in earnings and dividends. The various formulas are just different ways to look at, and try to understand, those relationships better. They're just very straightforward plus or minus formulas, to help people understand the concepts better, that's all. I trust my formulas as much as I trust anybody else's formulas – they're merely a framework to tie concepts together.

You also make the point that no precision should be assumed in their results.

Right. I see this a lot from Wall Street analysts, where they look at a company and say,

“According to our valuation, it's worth, \$10.70. Today, the stock was trading at \$10, so we think it's 6.3% undervalued.” That's specious. False precision. All you have to do is change your growth assumption by 20 basis points or your discount rate by 30 basis points, and suddenly, this company is fairly valued. So instead of trying to come up with a precise number, I focus on coming up with valuation ranges. If I do a discounted cash flow analysis that tells me that a stock is worth between \$9 and \$11 a share, and I can buy it at \$8.50, well, maybe that's not cheap enough. What you have to keep in mind are the limitations of the various valuation methodologies. Discounted cash flow models, for instance, tend to work well at the extremes. They keep you out of stocks that are dramatically overvalued, and it will also provide confidence to buy stocks that are dramatically undervalued. But when companies are more or less fairly valued, a discounted cash flow valuation isn't going to help you that much. You just can't expect any models to give you the ultimate truth.

Maybe we should talk about a stock or two that you do like here, and walk through your thinking process.

My favorite stock today is **Microsoft (MSFT)**. It's trading at only 12 or so times earnings –

You must not use its software!

Actually, it is a good example of why you have to differentiate between a good company and a good stock – and vice versa. I do use *Windows*. The thing is, the analysts are always fixated on what Microsoft's growth rate is. But my position is that the company's valuation today factors in absolute-ly no growth, or even probably negative growth. Yet the company, last quarter, grew sales around 18% y-o-y, and earnings around 14%. Now, the Street didn't like the quarter. Costs were “too high” because it is investing in its online business. Then too, *Vista* was not a great success, to say the least. Or was it?

Don't tell me you like Vista?

Clearly, it has problems. But you have to respect the company's competitive position when a “failed” product has sold 160 million copies. Microsoft *knows* that Vista has problems; it seems that not a day goes by without a new update from Microsoft. And in my personal experience, Vista's stability *has* improved. Vista will be fixed.

But Vista is scarcely all of Mr. Softee's problems. It's merely symptomatic.

Yes. Nonetheless, Microsoft grew earnings and revenues at YOY rates in the mid teens in the last quarter and that growth was across all products. I'd be happy if its growth rate was half as much. Today's valuation presents an incredible opportunity: I can buy this monopoly cash printing business for 12.5 times next year's expected earnings, and if I adjust for its \$23 billion cash pile, I am paying only 11.3 times earnings. That is actually half the P/E of the market, if you normalize the market's earnings. What this means is that I can buy a company that is so much higher quality than almost any other company out there, and I can buy it at lower than the market's multiple. In other words, I am buying it where there's absolutely no growth expectation priced in, and this is a company that has no debt and has more than \$20 billion of cash on the balance sheet.

You're comfortable, you're saying, with that margin of safety?

Yes. It's actually almost a perfect stock for this environment, in which we want to be sure that stocks have an extremely strong balance sheet and also want stocks that are cheap, even if we normalize their earnings and margins. The strong balance sheet is necessary because if we go into a severe recession, which is a very high probability, access to capital markets will become a privilege. It's already happening. During the booming bull market, by contrast, it came to be considered a birthright.

You merely had to be breathing. My dog was getting come-ons for credit cards.

You're right. And the same "standards" applied in the corporate world. But if Microsoft were to issue bonds, I could argue, and maybe only a little facetiously, its bonds would probably trade at a discount to U.S. treasuries.

It has a better balance sheet, hands down, but I'm not sure about the "full faith" part.

Okay, but look at its margins. Even when I normalize its margins and lower them a bit, the stock still looks cheap. As I said, I spend a great deal of time these days looking at companies and trying to figure out how vulnerable they are to margin compression, and Microsoft passes those tests with flying colors. Even if I model in very little growth in the future for Microsoft, I still come out with results saying the stock is worth much more than it is trading for today. That's why I feel comfortable buying it. You don't get these kinds of opportunities very often, where you can buy a company of this

quality at this incredible valuation.

I've heard that argument a lot lately – but applied to some of the financial stocks.

That's true. But there is one "minor" difference. Microsoft has no binary risk.

Binary risk?

When I say "binary risk," what I'm referring to is that with some financial stocks, I can see the possibility of them going down to zero as well as the possibility of making a lot of money in them. With Microsoft, I think the chances of a permanent loss of capital are *very* small. Someone could argue that you can make a lot more money in financial stocks on the upside, but my counter-argument is that I only want to buy stocks that I can analyze. I dare anybody to analyze **Bank of America** (BAC) or **Citigroup** (C). I actually looked at **American International Group** (AIG) on my blog five or six months ago when the stock had gotten down to around \$50. But when I looked at the annual report, I found \$40 billion of "other assets" on the balance sheet – and even though I looked through the footnotes, I couldn't find any explanation. So I called the company, and they said, "Well, it's other." That's when I realized that I couldn't analyze AIG and that nobody else can really analyze AIG. Another great example is **General Electric** (GE). It didn't bother me much that GE missed its earnings estimates. In fact, it probably showed that their earnings are better quality now than they were when it never missed a quarter under **Jack Welch**. The problem is that it also implies that even **Jeff Immelt** didn't have a good idea of what earnings would be when he was making estimates, which goes to the extraordinary complexity of the company. My point is, if you want to buy financials, that's fine, but buy the ones that you can analyze.

Is there any such animal?

The company that I like and a financial that I would want to buy (at some point, but not yet) is **American Express** (AXP) – because this is one of the few financial stocks that you can actually analyze; you can even model it. The company, over the last 5-10 years, has spun off all its complex businesses, so now it's a straightforward credit card issuing company and a credit card processor. My point is, there is a line between investing and speculating. If you buy financial stocks because they're beaten down, that's fine if you're a speculator and realize that a permanent loss of capital is very possible in those stocks. What is the probability of that? It comes

down to analysis. But can you analyze those stocks? Can you estimate what is the risk of a permanent loss of capital in those? Most people can't. The other thing I can't emphasize enough, for investors, is that it matters very much what you pay for a stock in a range-bound market. It's why I am paying so much attention to multiple compression and margin compression.

What other stocks do you think have good chances of withstanding that pressure?

Nokia (NOK) is another darling of mine here. I have to pinch myself that I can buy it so cheap. It dominates the cell phone industry. For the most part it competes with conglomerates like **LG Electronics (066570/KOSPI)** and **Samsung Electronics (005930/KOSPI)** that "also make cell phones" in addition to refrigerators, flat screen TVs, etc... **Motorola (MOT)**, a onetime wonder, is trying to get out of the cell phone business. Nokia's size provides it with an incredible competitive advantage.

Which is?

It is the lowest cost producer and at the same time it spends significantly more on R&D than its competitors. It has a market capitalization of \$95 billion, with \$15 billion of net cash (cash less debt) in the bank. In 2007, it generated about \$10 billion of free cash flows.

That much?

Yes, we are paying less than 8 times free cash flows here (if you take out cash) for the business. And this business has a return on capital in the mid 30s.

The market seems to be saying it's past its prime, though –

The stock is down because Nokia has a weak product line up this summer, but it should introduce its next "hot" phones later this year, maybe early next year. I can wait – especially because I'll be collecting a 4% dividend in the meantime.

The impression is, too, that Apple (APPL) is eating its lunch. Have you visited an Apple store lately?

Of course, there is competition from Apple's *iPhone*, but Apple sold 1.5 million *iPhones* a quarter in 2007, while Nokia was selling 1.5 million phones *a day*. Nokia will not let Apple and **Research in Motion (RIMM)** have the smart phone market all to themselves. They'll come out with a competitive product; it is just a question of when. Also, the U.S. market is a free call

option for Nokia. Only a few percentage points of their total sales come from the U.S. I've stopped predicting when they will turn their U.S. effort around, but they will, at some point.

Or not...

I suppose. But the margin of safety I have there is enormous. There are similarities between Nokia and Microsoft on that score: Both have incredible balance sheets – with huge net cash positions. And a strong balance sheet is paramount. Meanwhile, both of these companies are so cheap that there is absolutely no earnings/free cash flow growth priced into their valuations.

Any other examples?

I think some of the HMOs – like a **UnitedHealth Group (UNH)** or **Wellpoint (WLP)** – are very interesting. Even if I use a discounted cash flow model and factor in declining cash flows at 7% a year for five years – a very grim and unlikely scenario – and then slap a multiple of only 10 times cash flows on them at the end, I still get intrinsic values that are higher than where the stocks are today. There is plenty of margin of safety in these stocks.

Then why are they so cheap?

Well, there is a valid fear out there that the HMOs will start a price war to win market share. But I think this is a very unlikely scenario because the industry has consolidated tremendously over last decade. The top four players now account for 80% of industry revenues and they are all about the same size, more or less. Which says to me that their behavior is likely to be a lot more rational than maybe it was in the past. Then too, there is another similarity that Microsoft and Nokia and these HMOs share. They're all likely to capitalize on their stocks' weakness by buying back a lot of shares – and create plenty of shareholder value in the process.

One of the points you make in your book is that stock buybacks aren't *always* a good thing for shareholders –

That's very true. But these companies have strong balance sheets. They've been consistently using excess cashflow to buy back stock. What's interesting is that their current undervaluation provides these companies with an opportunity to buyback 10%-15% of their outstanding shares right now, at very favorable prices. So the decline in their stock prices actually has the potential to create value for long-shareholders. This is completely different than

companies going out and using cash flow to buy back wildly inflated shares. Unfortunately, I see a lot of companies that were buying back stock over the last two years, at much higher prices, now saying that they're not going to buy back stock because they're concerned about the economy. The problem is, this is the time they should be buying, because their stocks have declined so much.

**Maybe their cash flow isn't really so "free."
Anyway, another worry weighing on HMO shares
is political risk—**

Yes, they have political risk, but I think the fears of political risk are overblown. Reason No. 1 is that if you look at the publicly traded HMOs, they had revenues last year of \$250 billion. That's a lot of money, but they only made, as a group, total earnings of \$13 billion, which works out to a 5% profit margin and a 5% return on capital. If you look at those numbers, what the industry already reminds you of is a government-regulated utility. No. 2 is that 82% or 83% of their revenues go to pay doctors, hospitals, etc. Another 3-5% of revenues go to paying taxes. So you truly can't milk that cow for much political gain.

**They get criticized a lot for driving up
administrative costs and complexity – not
to mention sometimes huge pay packages
for executives.**

Sure, but at the end of the day, government is so inefficient, which would be worse? Even if we go to some kind of government-owned HMO system, these guys will probably run it, because everyone recognizes the government doesn't do a good job running things. So the political risk is overblown. And it's certainly priced into their valuations. Besides, if you're going to socialize our healthcare system, that means more people are going to be insured. They say something like 45 million Americans are uninsured now, which implies that there would be 45 more million new customers. That might offset some of the negatives from things like lower pricing.

**One thing I haven't asked is how long you
expect this range-bound market to drag on?**

Because this range-bound market started at a valuation level that was so much higher than

the previous ones, it may last longer. I have no idea how much longer. It really comes down to the earnings growth rate, and to how much P/Es deflate. I did all the math in my book, but if net earnings growth averages 5.5% and the final P/E is 14, it will take this secular range-bound market until about 2020 to run its course. If those assumptions are too optimistic, obviously, it takes longer. But please, don't shoot the messenger,

Banish the thought. Thanks, Vitaliy.

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