WealthTrack

Consuelo Mack interviews David Dreman

CONSUELO MACK: this week on WealthTrack rare in depth sessions with two of the most successful fund managers in the business…David Dreman and Christopher Davis explain how they invest for the long term with such sterling results… learn about the value of value investing

Next on WealthTrack.

Hello, I'm Consuelo Mack. Welcome to this special value edition of wealth track. Our guests are two of the masters of value investing, both of whom have established enviable track records over a period of years.
As a style, value investing has beaten growth for the last five
Years and according to the research firm Ibbotson associates its outperformed both growth and the market for decades… but what is value investing? For these celebrated investors it means buying the stocks of companies that they believe are under priced by the market for any number of reasons. Their stock picking prowess is based on confidence in their research and the patience to wait - sometimes for years - for the market to recognize the intrinsic value of their shares. It's not a quick or easy path to profits, but these two have proved the rewards can be well worth the wait.

Christopher Davis has value in his blood. He is the third generation to lead the firm that bears his name… Chris co-manages the family's highly-rated flagship fund, Davis NY Venture and its no load equivalent, Selected American Shares…Davis and his firm have recently been chosen to manage the well-regarded Clipper fund, as well. In a recent interview I asked Chris to describe what value investing means, and how he does it.

CHRIS DAVIS: Well, I always think that value investing is sort of a redundancy. I mean, investing is a process of buying a business today that you think will be worth more in the future, so you're buying it because you think it is undervalued. Now growth, which people sometimes think is the opposite of value, growth is actually a component of value. We all would want to own a business that grows profitably over time, it would be more valuable. So value investing shouldn't stand out as a separate school compared to growth, but instead maybe as a shorthand for reflecting on firms that do their own research, that do fundamental work, and really think about trying to determine independently the value of the businesses they invest in.

CONSUELO MACK: So what are the characteristics that you think really differentiate yourself from the rest of the pack?

CHRIS DAVIS: Well, we look at the characteristics that somebody would look for if they were buying a business in their neighborhood. In other words, if they were buying the entire company, they would think about things like, well, what sort of

business is it? Is it a good business, is it a profitable business, is it a business that can grow over time? What is the competitive landscape looking like? They would also spend time looking at who's going to run the business? Do they have an honest partner who's going to manage that business day to day? Those sorts of characteristics are important, but what else would they ask? Well, they'd ask, how much do I pay? Because obviously a business that might be very attractive to buy for a hundred thousand dollars, might be a terrible investment if you paid a million dollars.

And yet somehow people don't necessarily see those two questions as so closely related. What kind of businesses do you want to own, and how much do you pay for them? Well, if you're buying the neighborhood dry cleaning business, that seems obvious, and yet it's the same principle if you're buying a share of a global business, like General Electric Corporation or American International Group, it's the same discipline of, what if we bought the whole business? What do we play versus what do we get? Do we get value for money?

CONSUELO MACK: And what are the kind of key criteria for value for money? What are the kinds of things that you look for, I mean aside from the management you just talked about, and whether it's a good business, but what are the kind of key financial markers that you look for?

CHRIS DAVIS: Well, we think a lot about how much the business earns relative to what we pay for it. Now people say, oh, you must just mean the PE ratio. Well, yes, except that GAP earnings can be wildly overstated or understated. In other words, GAP earnings are...

CONSUELO MACK: General Accounting Principal earnings.

CHRIS DAVIS: Exactly. What are reported, when a company reports their earnings, they report GAP earnings. Now, when a company reports its earnings to the tax authorities, it chooses accounting policies that reduce current income, and that's perfectly legal, and obviously in the company's interest, so they make esoteric decisions to expense things that they could capitalize, or accelerate depreciation, just the way any normal person does on their own tax return, within the law. When companies report their GAP net income they often feel they have an incentive to do the opposite, to choose accounting policies that make current earnings look as high as possible.

The truth is usually in between, so it's not just a PE ratio, you have to look through the numbers, look through the footnotes, look at the cash flow statements, and try to really understand how much cash does that business produce, relative to what you pay to buy it? So, in a sense I would call that maybe an adjusted PE, you want to look at dividend ... capital reinvestment. Is that a management that is going to reinvest your share holders' equity, your retained earnings, at good rates of return, or are they going to build an empire to themselves? Those questions for a long term investor are going to be critically important.

CONSUELO MACK: One of the other kind of hallmarks of the Davis Funds is that you do not shy away from controversy or scandal, and you've made some sizable investments in companies in the past, I mean Tyco, for instance, that have had real ... that have been under the spotlight as, you know, associated with scandals. So how do you see kind of beneath the scandal, to see whether or not it's a company that you want to get involved in, even though it might decline in price for, you know, a number of months, if not a year or so?

CHRIS DAVIS: Well, the Chairman of Wal-Mart, Lee Scott, he was talking about another subject, but he made a very powerful comment. He said, you can't do what everybody else does and expect a different result. Now, the only way to add value as an investor is if you feel that there is some reason that a stock is mispriced. Now the reason that it would be mispriced if you were a buyer, is if it was worth more than everybody else thinks it's worth. So you have to look for what are the sort of circumstances that would cause such a mispricing? Well, one of them is fear. When people are afraid to own a company, it's in the headlines, it's scandal ridden, they want it out of the portfolio, they don't want to see it, they know it must be bad.

That sort of scandal can create terrific opportunities. Businesses, many businesses, are very durable, and yet they get tarred with the taint of scandal, the valuation goes down, and you have an opportunity to buy what my grandfather called a growth company in disguise. You know, a company that's disguised by the scandal, and companies, as I say, are very durable. Remember in the early '90s, when everybody thought Citicorp was going to go bankrupt? I think it was trading at a split adjusted probably a dollar or two dollars a share. When Warren Buffett in the late '90s, they said, oh, he's lost it, he doesn't understand the Internet ...

CONSUELO MACK: Right.

CHRIS DAVIS: You know, these sorts of opportunities. They don't have to be big scandals like Tyco was, they can be indifference or cynicism, but any reason that a business might get mispriced, those are the sorts of opportunities we look for, and as you said, scandal is often the best. When it's in the headlines, it's in the price, that's ... we want to look for things that can get better.

CONSUELO MACK: Now, one of the other things that really separates the Davis Funds' approach from many others as well is that the average equity fund, stock fund, has a pretty high turnover rate, and yours is low relative to your competitors. So you tend to take big positions in stocks, and stay with them for a number of years. So you actually ... you don't mind riding a stock up or down? I mean, you know, do you trade within these stocks? I mean, how do you handle the kind of volatility so that you're actually keeping a position in some of the stocks that you hold?

CHRIS DAVIS: Well, they say, and Ben Graham famously said, in the short term, the market's a voting machine. In the long term it's a winning machine. And what he meant by that is prices fluctuate in the short term, and by short term I don't just mean one year, it can be two years, three years ... (Overlap)

CONSUELO MACK: Right.

CHRIS DAVIS: The prices fluctuate based on psychology, and we all know psychology is inherently unpredictable. There's nobody I know that's gotten rich making a forecast about what the market's going to do next year, or one year later, or one ... and swinging in and out of the market trying to time these things. But in the long term, it's a weighing machine. It weighs the value of the business. So if a company builds its value over time, and you didn't overpay for it in the beginning, then time is your friend. The business becomes more valuable, and of course from an after tax point of view, it's even more glorious, because you're deferring that gain longer and longer versus trading in and out and having to pay taxes and commissions every time you do.

So we think doing research, buying good businesses where time is your friend, that you can own for the long term, we think that that's the way that has worked for us over a long period of time, and it makes sense. We haven't heard a lot of other investment philosophies that make sense. Rotating into this sector, high turnover, high cost, high taxes, doesn't make sense to us. You know, we eat our own cooking. So we're the largest share holders in the funds that we manage, so those things really matter to us.

CONSUELO MACK: There is a chart showing some statistics that we got from Jack Bogel, the founder of Vanguard, from his research center, showing how the market has performed over the last 20 years, versus the average equity fund, which has performed more poorly than the market, underperformed the market, and versus the average individual invested in those equity funds, how much worse the individual investor has performed over the last 20 years. Explain that underperformance. We call it the underperformance trap that individual investors find themselves in, and how we can get out of it.

CHRIS DAVIS: Well, Jack Bogel has done a great service to investors by getting this data out. The first gap, which is the funds underperforming, that tends to be driven by costs and turnover. You know, the average mutual fund has turnover of over a hundred percent. That means they buy ... (Overlap)

CONSUELO MACK: A year. Right, right.

CHRIS DAVIS: A year, every year they're buying and selling and buying and selling. You think of all those commission costs plus the high management fees and all of the expenses that are built into that ... (Overlap)

CONSUELO MACK: And capital gains taxes.

CHRIS DAVIS: And taxes, especially if you tax effect the numbers, that's the first gap. Now that's how my partners and I judge our results. How did we do relative to the market over time? We want to beat the market over a long period of time, and we've been fortunate that we have over, I think every ten year period since 1969, that's how we keep ... But the second gap, and this is where Jack's really done a valuable service, is he's emphasized that second gap is just as important. The average investor getting in and out of funds, has incurred another cost.

CONSUELO MACK: Well, what is that cost? It's not commissions, that's in the first one. The cost is the timing of their own investment decisions. What happens is they get in, they want to chase whatever has worked in the last few years. So they want what's hot, what's already gone up. Well, this is hugely destructive. Now there are other reasons. They might react to the general environment. Remember when the market was near its peak, people were pouring money into funds. When the market was near its low, people were taking money out.
Well, the result is that, however the funds did for that period, the investors in the funds did worse, because they were more in when things were overvalued, and fewer in when they were undervalued. That is a very powerful trap. final question. This particular period of time, we've just come out of a period of time when the last five years, Index funds, for instance the S&P 500, has not done well as an investment. So if these things go in cycles, what kind of a, you know, what do you think, who's going to do better? Are actively managed funds going to tend to do better, or Index funds in the next five year period? (Overlap)

CHRIS DAVIS: Well, it's hard to say, but if I had to guess, I would say that the typical pattern is that an investment strategy becomes most fashionable at exactly the worst time to go into that investment strategy. And I think in a way the peak of Indexing, for this part of the cycle, may have been in the late '90s and into the last several years, and we may be in a period where active managers do for this decade in general do better, provided their fees are reasonable, their turnover's low, and remember, share holders should be looking at after tax returns, if they're taxable.
And so we think that with those provisions, I wouldn't say all active managers will do, there are many that have outrageous fees, but in general, I think that we're in a period where it's going to be easier, and it has been easier to beat the Index over this sort of period than when the Index is marching ahead, as it did in the '80s and '90s.

CONSUELO MACK: Chris Davis, Davis Funds, thank you so much for being with us.

CHRIS DAVIS: Thank you, Consuelo.

CONSUELO MACK: Our second guest is considered the dean of contrarian investors. He's even written a book called "Contrarian Investment Strategies." His

name is David Dreman and he’s chairman and chief investment officer of Dreman Value Management. His deep value approach to stock selection often leads him to invest in some controversial companies, but this strategy has accounted for phenomenal long-term success. His Scudder-Dreman High Return Fund has posted average annual gains of nearly 17 percent over the past decade and a half, which puts it well ahead of the S&P 500 Index and the average value fund. I recently asked Dreman why he sticks with so many of his investments for the long haul?

DAVID DREMAN: What we found is in just the empirical backing for this is that if you buy good companies they tend to have good returns for a long period of time. If a company, for example, is turning 15 percent in the first year, it might return that percentage on average over five years.

CONSUELO MACK: And when you talk about a return at 15 percent, you're talking about both price appreciation and dividends, for instance?

DAVID DREMAN: Yes. The two together.

CONSUELO MACK: And how important are the dividend returns to your view of a valuable investment?

DAVID DREMAN: Oh, they're really very important because over time, certainly not today, but over time, dividends were as big as appreciation. And so, companies are compounding, say, five percent dividends are going to have a nice record if they have some appreciation with it over a five-year period. Whereas a company that has the same appreciation with very little dividend is going to be well behind.

CONSUELO MACK: You have a history of buying distressed companies, I mean companies, basically, you'll notice a contrarian that no one else would touch with a ten-foot pole. And among the companies that you've bought over the years are the old Altria which basically is the name for Philip Morris now.

DAVID DREMAN: Right.

CONSUELO MACK: Which is still being sued left and right by numerous parties and companies like Tyco, kind of at the height of their management scandals and Fannie Mae and Freddie Mac, which are definitely under public and governmental scrutiny.

DAVID DREMAN: Yeah.

CONSUELO MACK: So, when you look at the returns that you get from these distressed companies, how can you tell the difference between what's a really good company underneath it all and what is really a company that's in trouble?

DAVID DREMAN: Well, you can't always but I think if you do some thorough analysis, you can really find the differences. For example, back in the 2000 or so, the tobacco companies had lost a major case in Florida. It was called the Angle Case back then. And the award was something like $150 billion and the companies just fell apart, all of them. Philip Morris was actually down, say it's something like 70 today ... it was 17 back then. And it was paying a ten percent yield. And I guess the general investment public thought these companies were heading for bankruptcy. But if you put some time into the research, it was pretty easy to see that the case was really badly run. So, it really is a matter of research. And you know that people will over-react. And I think what we do as contrarians or we try to do is there's a fair amount of psychology, I guess what they call behavioral financing ...

CONSUELO MACK: Right. Which you've written about, actually. in ...

DAVID DREMAN: Yes. I've spent a lot of time studying it and knowing it. We've all got the same emotions. When a stock drops, we think there's no bottom. (Laughs) Some people say it. But really, if you have a good company and a solid company, not much is going to happen. Just figure the Philip Morris example again. Even if Philip Morris had lost the Angle Case back in 2000, that was only a subsidiary of the company. And the assets there were maybe oh, 25 percent of the assets of the overall company. So that most of the earnings power were in Kraft and Philip Morris International. And they could not be taken. So, that was almost like shooting ducks in a barrel. Although, it's hard on the investor, it's even harder on the manager because you're going to get enormous criticism.

CONSUELO MACK: Which you did. I remember it well.

DAVID DREMAN: Yes. (Laughs)

CONSUELO MACK: I'm sure you do too.

DAVID DREMAN: (Laughs) I certainly do. You have to be able to, I guess, have the ability to have a few stones - or maybe a lot of stones - thrown at you.

CONSUELO MACK: You mentioned that there are some sectors in the market that look very attractive right now. What are they?

DAVID DREMAN: Well, I'm a believer in energy at this point We started to buy energy about the beginning of 2004 and in the past there's always been enormous excess capacity. So the OPEC would have two million-plus barrels a day and the other suppliers would have more. And prices have to be kept up somehow. And that was done by production. But by last year, the demand had fully caught up with all production. And there was no more supply.

CONSUELO MACK: And so, do you see any change in that equation? I mean, could there be enough new supply to come on that it would meet demand? Or could demand possibly decrease enough that it would meet supplies that would become more in balance?

DAVID DREMAN: I think it's doubtful. Because right now, unless there was a major, major, not even a recession but a depression, people will continue to use oil. And we're just not finding it. And so, I think we're probably going to have levels, the prices around 50, 60, maybe even higher for gas.

CONSUELO MACK: A barrel of oil?

DAVID DREMAN: Unfortunately, for years to come

CONSUELO MACK: Uh-huh. So when you look at the energy stocks after the big run-up, what kind of value do you see in the companies themselves?

DAVID DREMAN: Well, we see pretty good value. Because take a company like ConocoPhillips, it's trading at about eight times earnings, which is about less than half the price of the average stock in the S&P. It's paid down its debt entirely. It has enormous cash flow. And it will be buying back its own stock and it'll be increasing its dividends. And given those conditions, I think that it will probably get at a somewhat higher price earnings ratio over time or appreciate reasonably well over time. Only simply that the price goes up because the earnings are steady and growing some. Now, if energy bolted much higher, I think it would be even better.

CONSUELO MACK: Is there any other sector, David, that you find very attractive as a value manager?

DAVID DREMAN: There are a number. I guess one is the financial sector, which is really going down...

CONSUELO MACK: Banking?

DAVID DREMAN: Banking. I guess Freddie Mac and Fannie Mae are ...

CONSUELO MACK: Right. The government-sponsored venues. They're giant mortgage ... right.

DAVID DREMAN: Right.

CONSUELO MACK: Underwriters?

DAVID DREMAN: Right. Banks tend to go down when inflation starts to move up. And that's what we're seeing. We're seeing them at big discounts to the market,

although they've had excellent growth over time. In fact, the banking index has outgrown the S&P by ... it's outperformed the S&P earnings over the last decade. And Freddie and Fannie have been much better performers than the banks. And yet, in this environment that the banks aren't in favor. And we think that what has happened in the past is that after, say, a couple of years, with inflation going up and earnings holding up and the banks are much more sophisticated now in their loans. They don't borrow short and lend long, which has hurt them in the past. And so, a lot of these may be 65 percent company services now. So, we think these are excellent companies over time. And the market will again begin to realize this as earnings hold up.

CONSUELO MACK: Final question. How much does it worry you that value stocks have out-performed growth stocks by such a huge margin over the last five years?

DAVID DREMAN: (Laughs) Really, not much. Over time, and actually the only empirical studies that go back are on these value stocks, low PE ratios, low price book and so forth. They've out-performed about 60 percent of the time. There are periods where value out-performed for a very long time. And normally, after the ... there was a bubble back in the Seventies. A period where growth really out-performed enormously. And then, value out-performed growth for 11 years running from the late Seventies on. And of course, the biggest bubble, I guess of all time, probably exceeding Tulips, just ended in 2000. And so, I think we have a ways to go yet.

CONSUELO MACK: David Dreman, thank you so much for joining us.
Near the close of every WealthTrack we suggest one action you can take to build and protect your wealth over the long term. And today's suggestion only works over time…
Today's action point: start taking advantage of the incredible power of compounding. You need an investment horizon of at least a decade or more to do it, so it also works beautifully for a child or grandchild.
Dow Theory newsletter's legendary editor Richard Russell calls the compounding interest tables the "Money Bible", the royal, safe, sure road to riches that anybody can travel.
Russell's example shows a nineteen year old investing 2000 dollars a year for just seven years until he or she is 26. Then stopping and letting the power of compounding take over. Russell assumed an average growth rate of ten percent a year, seven percent interest plus growth… at that rate, the initial 14 thousand dollars turns into more than 944 thousand when the investor turns 65.
Compare that to an investor of the same age who starts investing seven years later and starts putting $2000 dollars a year into the market every year until she is 65. That 80,000 dollar investment, with the same returns, generates only about thirty thousand dollars more by age 65. And when you subtract the original investments of 14,000 and 80,000, our investor who started saving at nineteen comes out ahead.

Those seven earlier years and subsequent compounding interest made a big difference… incidentally the power of compounding works for stock dividends too. According to finance professor Jeremy Siegel the bulk of the stock market's real returns over the last century have come from dividend reinvestment and the power of compounding.

And that concludes this special value edition of WealthTrack. Thank you so much for joining us…For more information about WealthTrack and our guests, check out our website at wealthtrack.com. We look forward to your questions and comments.

Have a great weekend and make the week ahead a profitable and productive one.

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