They Come With Warts

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Dear Fellow Investors:

We are traveling around the US giving a talk about a template for managing equity portfolios which can be used for choosing active managers. Our theory is that the average active manager cedes too much advantage to passive indexes by being overly-active (averaging more than 100% turnover vs. less than 5% for the S&P 500 Index over the last 18 years), by under-owning high quality and ignoring significant undervaluation. In this missive, we'd like to talk about why most investors underestimate the importance of undervaluation because it usually comes with warts.

Studies led by Nicholson, Fama-French, Bauman and Dreman have all come to the same conclusion. Broken into quartiles or quintiles, the index produces significantly better results by owning the lowest Price-to-Earnings ratios, Price-to-Book ratios, Price-to-Cash Flow ratios and Price-to-Dividend ratios in both the short run and over very long stretches of time. It happens both on a static and annually readjusted basis. It has been true in every country study and in each of the three stock market capitalization levels (Large, Mid and Small). Why don't more active managers stack these probabilities in their favor? We believe the answer is warts. They just can't stand to look at owning these out of favor securities and are afraid they will get fired before these ugly ducklings come back into some kind of favor.

We think you'll understand this if we look at a specific and current example of these circumstances. Big Pharmaceutical company shares are in the lowest quintile by Price-to-Earnings ratio, Price-to-Cash Flow ratio and Price-to-Dividend ratio. It is a veritable triple whammy of undervaluation! However, just look at the warts. Merck reported earnings last week. They reserved for leftover Vioxx litigation. They are in arbitration with Johnson and Johnson over the rights to Remicade. They are losing patent protection on important products and facing the stingiest FDA approval process which has been seen in decades. If all that is not enough indignation, the President of the United States has used the industry as a punching bag for the last two years. The same basic story is true for Amgen, Bristol Myers, Pfizer, JNJ and Abbott Labs among our portfolio holdings.

History proves that the best time to buy these out of favor areas of the market are when the warts are the biggest and the alternatives are the most attractive. Ten years ago, folks were agog over technology stocks and wanted nothing to do with energy producing investments at $11/barrel of Oil. There was no hope for the industry. They were in the low quintile for Price-to-book, Price-to-Earnings and Price-to-Dividend yield. They have been spectacular on both a relative and absolute basis since then. Twenty years ago, in the aftermath of the Savings and Loan/Banking Crisis of the late 1980's, bank shares sold for less than book value, mega-low PE's and offered above-average dividends. They were the stars of the next fifteen years in the market.

The wait typically isn't as long as most equity managers or asset allocators think. Research we use in our presentation shows that equity research analysts do a great job of predicting next year's results for companies based on PE ratios. The highest PE companies produce the best earnings growth and the lowest PE companies produce the worst earnings results. But over one year, the lowest PE stocks outperform the average by 3% and the highest PE group underperforms the index by nearly the same percentage. Our conclusion is that managers who stack these favorable odds in their favor and buy some Compound W should ultimately attract a great deal of interest from asset allocators when the warts fall off.

Best Wishes,

William Smead

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