

5 YEAR FORECAST & OUR INVESTMENT APPROACH

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“Market commentators and investment managers who glibly refer to “growth” and “value” styles as contrasting approaches to investment are displaying their ignorance, not their sophistication. Growth is simply a component – usually a plus, sometimes a minus – in the value equation.”

-Warren Buffett

At the time of this correspondence, the week ending March 16, 2001, the major indices showed considerable weakness. More specifically, the Dow Jones lost 7.7% for the week, its largest decline since the 7.8% loss during the week ending October 13, 1998. The Nasdaq fell nearly 7.9% for the week, leaving the index 62.5% below its peak of 5,049 on March 10, 2000. Finally, the S&P 500 fell 6.7% for the week. It has lost a quarter of its value from its high of 1,527 last year. Suffice to say, the U.S. stock market is considered to be in “bear market” territory. Speculation as to when a bull market environment will return is natural. Our view is that while a popular activity, such speculation is of little value. More important is an understanding that investing requires forecasting future economic conditions within a sound valuation framework.

Our forecast for the economy is for modest secular real growth in GDP, with inflation under control. Fiscal policy is likely to be somewhat stimulative as a result of tax cuts. Corporate profitability will likely lag due to pricing pressure from excess capacity in most industries. Further near-term easing by the Federal Reserve should result in interest rates staying within a narrow range.

Current valuations are still problematic. The mere fact that many stocks are considerably lower than they were a year ago does not necessarily make them attractive for current investment. The leading stocks in the last half of the previous decade, namely large-cap technology and mega caps, remain expensive by most valuation metrics. For instance, despite Intel’s stock decline of about 65% from its high, the current price is five times revenues, as compared to a valuation low in 1997 of three times revenues, the latter at a time when future growth was higher than the current forecast.

The later stages of the previous bull market were characterized by investor complacency with regard to valuation, which allowed for creation of a “bubble” that has subsequently burst. Yet an overly simplistic analysis using comparisons of stock prices from that period of “irrational exuberance” with today’s prices most likely will lead to poor investment decisions.

Interestingly, we are often asked whether we are “growth” or “value” managers. You need not look any further than Warren Buffett’s comments in his annual letter to shareholders to understand that growth and value are not mutually exclusive. We believe the stocks we are purchasing are undervalued based upon our expectation of their business prospects and their current valuations on an absolute basis. We first gather data we view as reliable and relevant, and then use a sensible approach that does not require speculative, aggressive assumptions about the future being different from present realities. Only then can we draw conclusions from the data in a sound valuation framework.

The present norm in our industry is for investment managers to consider relative attractiveness and benchmark weightings much more so than whether or not buying the stock will provide an acceptable return over a reasonable time period. Not succumbing to this norm may be one of our greatest advantages.



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