DIAMOND HILL®
investments

"IN THE LONG RUN"

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At Diamond Hill, our core investment tenets encourage independent, businesslike, and long-term thinking. This piece discusses our thoughts on what constitutes the long-term and some of its practical effects on our investment approach.

The Eagles wrote a song about it. Every first year economics student learns to define it. And investment organizations espouse it often enough that it might be regarded as a cliché. "It" is the long run. In certain contexts, the long run cannot be defined as a specific time frame. For instance, the economics student learns that in the short run at least some costs are fixed, while in the long run all costs are variable. Neither should self-interest be allowed to influence an objective definition of long-term. Fund companies have an incentive to define long-term as a very long time, perhaps forever. However, a skeptical mutual fund observer could become downright cynical when considering the hypocrisy of fund companies preaching long-term investing on the part of their shareholders, while the fund managers themselves play a distinctly short-term game as evidenced by portfolio turnover rates easily exceeding 100%.In the end, we may be able to do no better than Supreme Court Justice Potter Stewart, who in writing a concurring opinion in an early obscenity case refrained from giving specific definitions, but stated "I know it when I see it." Legal scholars among you might know that Stewart himself later recognized that the vagueness of his earlier opinion made it untenable in a legal context. If, like Potter, we are too vague in our definition of long-term, check back with us when we are represented on the Supreme Court. In the meantime, hopefully this shares some thoughts on what long-term investing means to us.

Classical Economics vs. Keynesian Economics

Debates about long-term and short-term are not new in the sphere of economic policy and investing. Henry Hazlitt, in Economics in One Lesson, wrote "the art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups." While Hazlitt thought some might find this obvious, he assured readers that it was anything but orthodoxy:

> Yet when we enter the field of public economics, these elementary truths are ignored. There are men regarded today as brilliant economists, who deprecate saving and recommend squandering on a national scale as the way of economic salvation; and when anyone points to what the consequences of these policies will be in the long run, they reply flippantly, as might the prodigal son of a warning father: "In the long run we are all dead." And such shallow wisecracks pass as devastating epigrams and the ripest wisdom.

Here, the object of Hazlitt's disdain is John Maynard Keynes, who wrote, "But this long run is a misleading guide to current affairs. In the long run we are all dead. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is long past the ocean is flat again." Keynes had a very successful investment record and wrote insightfully and eloquently about investor psychology. Also, his often quoted "in the long run we are all dead" might be better kept in context as a reminder that we must also live in the short term. Yet, in setting economic policy, Keynes believed in government intervention to solve short-term "disequilibriums," distrusting free markets and the price mechanism to do their work. In short, if "problems" [lack of aggregate demand] were ever encountered, somebody [the government] should DO SOMETHING. While a full discussion of classical and Keynesian economics is well beyond the scope of this piece, we think it is appropriate to keep in mind the seemingly trite Latin saying- primum non nocere – "First, do no harm."

One story to place this in an investment perspective involves Diamond Hill's Chuck Bath. In the 1990's,Chuck was interviewing with a Fund organization, now part of a major multinational bank. As part of an idle conversation with a manager in that organization, Chuck mentioned that the mutual fund he was then managing had underperformed the previous week. That manager's immediate question, "What are you going to do about it?" The answer, in deed if not words, was nothing. Our approach is much the same today. Given that we believe short-term stock price movements are as much a reflection of investor psychology, we would not expect to engage in major portfolio overhauls in reaction to such fluctuations.

A Short Term Investment Approach

Some might point out that the long-term is actually a series of short-terms. This fact is explicit in fixed income markets, where investors might attempt to predict the theoretical term structures of interest rates by considering a series of forward zero-coupon curves in a process called bootstrapping. But is there something to be gained in equity investing by predicting a series of short-term events? Perhaps it would be useful to consider a short-term investment approach, such as earnings surprises. This approach might best be described as attempting to choose stocks that the manager believes will surpass the "consensus estimate" in the next reported quarter. This approach has logical aspects. If a stock is reasonably efficiently priced, then it should respond to the marginal piece of news.

There are a few major drawbacks to this approach, however, in our view. First, if a stock is inefficiently priced, why should it necessarily respond to marginal news in the direction anticipated – higher if the news is good and lower if bad? Second, there is great risk in concluding that the earnings estimates of a few sell-side analysts are the actual expectations embedded in a stock price. In his book Wall Street Meat, Andy Kessler relates a story from a Microsoft analyst meeting in 1991.Kessler worked at Morgan Stanley covering companies such as Intel, but did not cover PC software, so he was there only as an interested observer. Amid presentations about Microsoft products, Microsoft President Jon Shirley spoke:

> "I want to comment about your earnings estimates. There are certain analysts out there, and you know who you are, whose numbers are just TOO HIGH. They have got to come down." One-by-one, each of the sell-side analysts left the room, went outside, pulled out their cell phones and called their trading desks to tell them that Microsoft was talking down numbers. John Shirley finished his presentation to two people, Chip Morris, a buy-side analyst from T. Rowe Price and me. Analysts started filing back into the room, and word spread quickly that Microsoft's stock was down 4½ points…as I stepped out of the presentation room, there were Bill Gates and Jon Shirley standing there laughing as hard as they could. I heard Gates say, "What suckers, this is too much fun. "Microsoft was probably pricing their employee stock options the next week, and the timing of the analyst meeting was a fortuitous bang to the stock.

And if Kessler is accurate, this is an example of a company who sought a lower stock price. One can imagine the sandbagging, whisper numbers, pro forma earnings, and other games that developed in the corporate dance with Wall Street analysts from companies who sought higher prices for their stocks in the 1990's.

With the major qualifications above, we would concede that there could be some efficacy to an approach such as earnings surprises. Yet, it's simply not our approach. It is important to point out however, that it is likely a costly approach. Trading costs, short-term capital gains taxes, and the cost of attempting to acquire superior short-term information all will likely be high. Our own approach involves estimating the long-term value of a business based on the present value of its expected future cash flows. Then we look to the market price to discover whether an investment opportunity exists. If we worked backward, we would attempt to infer the long-term consensus expectations embedded in the current stock price, and find opportunity only when our expectations were more favorable than consensus.

An Example of Our Approach

In an early 2001 letter to shareholders of what was then the Diamond Hill Focus Fund, we reviewed a successful investment in Electronics For Imaging (EFII). To summarize, we bought in October 2000 at $11.50 per share, when the company held $8 per share of net cash and short-term marketable securities, and estimated potential "normalized" earnings of as much as $1 per share. In January of 2001,we sold our stake at a price of roughly $18.50.In that letter, we wrote:

> So how do we know if we were "lucky" or "skilled"? Our answer is that right now,we're not sure.But after we sell a stock,we continue to keep tabs on the company.If in two years time,we findthat EFII has burned through all their cash and has little economic earnings power,we'd likely agree"lucky" and that the perceived value was ephemeral.In other words,if we find ourselves consis-tently selling things "at the top" only to watch them crash after a sale,the relief we will feel as fel-low shareholders will be greatly tempered by concern that we are making mistakes in the beginning.

Let's update for subsequent events in regards to both the price and value of EFII. The first critical point is to understand the concept of a required rate of return, which is akin to an opportunity cost. If the stock was indeed worth $18.50 per share in early 2001,it should sell for a higher price today. Using required rates of return between 8% and 10% would yield an "appropriate" price for EFII of $27 - $30 per share today, which is approximately the price EFII has been trading at the past few months. Measured by today's price alone, selling in early 2001 was a "push," as we would have received an approximate fair return on the stock over the subsequent holding period (EFII has not paid any dividends over this period).In terms of subsequent fundamental value, EFII now has $5.60 per share in net cash and marketable securities after making a $280 million acquisition in 2005 (the share count is up just slightly from five years ago, and the company might have $10.50 per share cash without the acquisition).Including 2005,EFII will have averaged approximately $.75per share in earnings over the last five years, short of our expectation of $1 in "normalized" earnings which we would have assumed would have grown closer to $1.50 by now. Thus, we would conclude EFII today is fairly valued today if it can achieve "normalized" earnings of $1.50,growing at least at a high single digit rate. From today's vantage point, the bottom line would seem that at a price of $11.50 in early 2001,EFII offered a margin of safety whereas at $18.50 it did not.

There are a couple points worth making here. When analyzing the value of EFII, we used a long-term horizon. Earnings and dividends were estimated over an assumed five-year holding period, with a terminal value, or target price, assigned at the end of the fifth year. This terminal value is based in part on assumptions concerning growth and risk in years six and beyond, so the horizon theoretically extends forever, although the mathematics of present value render cash flows received in the very distant future inconsequential. Note, however, that we were short-term owners of the stock. The decision-making process was completely driven by price-value considerations. The goal of our approach is to achieve an attractive, risk-adjusted after tax return. Low portfolio turnover is often a means to achieve that end, but should not be confused with the objective. We anticipate that our portfolio turnover will be lower than many of our peers based on our approach. However, a finding of both high returns and portfolio turnover would not necessarily contradict a long-term investment approach. If, however, our returns are low and portfolio turnover is high, it would indicate either a deviation from the approach or evidence of mistakes in our initial analysis and purchase that then caused us to reverse course.

Conclusion

Equity investing is an activity that lends itself to a long-term horizon. In the past, we have suggested five years as the minimum amount of time over which to analyze the value of a business, as well as to measure the progress of an equity manager. Even five years could prove too brief if the end points reflect extremes in market psychology. As ever, we are reminded of Benjamin Graham's quotation that, "In the short run the stock market is a voting machine; in the long run it is a weighing machine."

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