

Insights from 40 Years on Wall Street



*By Shelby M.C. Davis
Senior Research Advisor and Founder
of Davis Advisors
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Often I am asked about the lessons I have learned in my four decades on Wall Street. Since taking the long view is worthwhile, particularly in volatile markets, this seems an excellent time to share with investors insights gathered over my investment career.

Stock Prices Fluctuate

The first point to keep in mind is that the stock market is like the weather. It fluctuates. Fair weather does not last forever and neither does foul weather. Fortunately, over the years, there seems to be more fair weather than foul in the market just as there are probably more days without rain than with rain in most parts of the world. Still when bad weather hits the market, it often comes on quicker and is more violent and like a tornado or hurricane can do a great deal of damage in a short time. Investors become gloomy just as they become euphoric over sunny times in the market. But it is important to keep your perspective that the market fluctuates and learn to accept the bad with the good.

The Market Always Looks Ahead

Also remember the stock market is a barometer, not a thermometer. In other words, it tries to predict future weather, not current conditions. As a result, the market often seems irrational. The market usually bottoms when

earnings are poor, stock prices low and investors filled with despair. At these times, scandals and headline worries often intensify the gloom just as they are now. On the other hand, the market usually peaks when skies look cloudless, earnings are booming, the game seems easy and investor psychology is bordering on euphoric. As we saw with the breaking of the bubble, the most dangerous time is usually when the experts are all optimistic. Warren Buffett, chairman of Berkshire Hathaway, put it best when he noted, "You pay a high price for a cheery consensus."

Bear Markets Concentrate the Mind

Bear markets concentrate the mind just as bull markets lead to sloppy thinking. When you are riding high and overconfident at the top of a bull market, decisions are often more impulsive and in retrospect often turn out to be poor decisions. We have just been through a bubble that inflated valuations beyond all reason. Now the bubble has burst and valuations are extremely cautious, but that can create opportunity. When times are tough, you tend to make razor-sharp decisions. You upgrade portfolio quality. You concentrate within your circle of competence. You build up holdings where you have the greatest conviction. In the future these tough decisions frequently turn out to be great decisions, even

though you were nervous and uneasy at the time you made them.

It Pays to Be a Long-Term Optimist

We think of investing as a long voyage where it pays to be a long-term optimist, stay on board with money invested and not worry much about market timing. The easiest way to show the importance of staying invested is with the Rule of 72, which illustrates how compounding builds long-term wealth. To see how many years it will take to double your money at any compound growth rate, just divide 72 by that rate. Assuming a 7% compounding rate, your money will roughly double in 10 years. Over 50 years, you will have five doubles—with the last 20 years being the most important doubling points because you are working with a greater principal amount.

For example, \$1 million compounding at 7% will grow to almost \$32 million in 50 years. In the first decade your money will double from \$1 million to \$2 million, in the second decade from \$2 million to \$4 million and in the third decade from \$4 million to \$8 million. Then it starts to get really interesting because the dollar amounts you are doubling are so much greater. In the fourth decade your money will double from \$8 million to \$16 million and in the fifth decade from \$16 million to \$32 million.¹

If you can compound your money at 14%, then your \$1 million will grow to more than \$700 million in 50 years. In such case, your money will double about twice as fast—about every five years, not every 10 years—and so you will have almost 10 doubles over a 50-year period. That is why we do not spend much time trying to decide on the overall portfolio's investment in the market. We know it is important to stay invested. But we do spend a great deal of time picking individual stocks within the portfolio.

Managements Matter

A key focus of our research is visiting managements and tracking their progress versus their projections. Some managements constantly overpromise and underdeliver. Building conviction about management—a process my father called separating the “doers” from the “bluffers”—is critical. I often say I want managements to say what they mean and mean what they say. In other words, I want them to be straight shooters, transparent and honest with the news, whether the news is good or bad.

Use Benchmarks as a Guide

Having a sense of basic historical trends is also important because these trends can provide benchmarks in assessing companies and the markets. For example, the U.S. economy, as measured by gross domestic product (GDP), has historically tended to grow in nominal terms between 4–6% a year, although sometimes with rapid inflation that growth has been higher. Corporate earnings have historically grown somewhat faster than GDP due to many factors, such as productivity, leverage and mergers of private companies into public companies. The long-term earnings growth trend for public companies as a whole has historically averaged roughly 7–8% a year.

These two long-term trends—4–6% GDP growth and 7–8% corporate earnings growth—are good benchmarks to keep in your head in appraising potential investments. While a few exceptional companies have been able to maintain 15–20% growth rates for a decade or two, these stocks tend to be very pricey, and the road is littered with growth forecasts that did not come true, as we have recently seen in the technology and telecom sectors.

Fairy tale growth of 15–20% a year ad infinitum in either earnings or stock prices should

¹ The examples used in this research report of compounding growth at 7% and 14% are hypothetical and used to illustrate a point. They are not predictions of future growth. Prices of shares will vary so that, when redeemed, an investor's shares could be

worth more or less than their original cost. The Rule of 72 provides an estimate of growth. For example, the Rule of 72 estimates that \$1 million will grow to \$32 million in 50 years, a fair estimate of the actual growth to \$29.46 million.

be looked at for what it is—a false assumption on average. Occasional interludes with this kind of growth do occur, as was the case in the 1990s when many investors compounded their portfolios at 15% or more a year. But these high growth rates are not normal and do not last indefinitely. Similarly, bad times for earnings and stock prices also come to an end. Over the long term the market should average growth of at least 7–8% a year in line with earnings and the economy.

Valuation Is an Art, not a Science

The longer you are in the market, the more you realize that the valuation of stocks and the market itself is an art, not a science. The average price/earnings multiple for the companies in the Standard & Poor's 500® Index has historically been around 17 times projected earnings, but wild swings in valuation do occur. During my 40 years in the market, I have seen price/earnings multiples go from around six times earnings to around 30 times earnings.

To cope with these wild valuation swings, one simple exercise is to ask yourself, "If I could afford it, would I buy the entire company at the market value implied by buying one share of stock at the current price?" For example, if a company has one million shares of stock outstanding and the stock's current price is \$10 per share, the company's market value is \$10 million. So if you had \$10 million to spend, would you buy the whole company for that price?

Asking yourself this question accomplishes several things. First, the question focuses your thinking on what you are actually doing when you invest in stock—becoming a fractional owner of a real business. Second, the exercise forces you to consider alternatives based on the valuation parameters that exist today. You cannot say, for instance, that you will never buy a stock for more than six times earnings if for decades the market has averaged 17 times earnings and in some years has traded as high

as 30 times earnings. Finally, the exercise helps you find the best relative value because, in making your decision, you will presumably compare the return you think you can earn by buying the company against the returns available on competing alternatives for your money, such as other stocks or bonds.

One widely used valuation yardstick is the Federal Reserve's valuation model. The Fed determines a fair value multiple for the stock market by dividing the yield on 10-year U.S. Treasury bonds into 100. According to the Fed model, with 10-year Treasuries notes yielding around 4.53% at the end of July 2002, the market would be fairly valued at a multiple of around 22 times expected earnings. Based on earnings forecasts from many market pundits, the Dow Jones Industrial Average and the S&P 500® Index are both currently valued at around 18 times expected profits, suggesting that the market may be perhaps 10–20% undervalued.

Of course, benchmarks only work as rules of thumb and no one has the perfect formula. Still, the Fed model supports our belief, as we have stated many times in the past, that the market is likely to trade predominantly in a range of 10,000–15,000 over the foreseeable future. Even if the Dow were to increase 30% to around 11,000, it would still be in that trading range. Correcting the overvaluation associated with the market bubble may take a while longer.

Risk Control Is Critical

You also need to recognize that you will make mistakes in stock picking just like batters—even the best batters—sometimes strike out in baseball. In baseball, a player who gets a hit every one out of three times at bat has a batting average of .333 and is considered an exceptional hitter. Knowing that you will make mistakes, the key in stock picking is to manage risk in order for your "hits" to really pay off.

Suppose you invest \$1 each in three stocks and over the course of a year one stock rises 50% to \$1.50 a share, one falls 20% to 80 cents a share and one remains flat at \$1 per share. Disregarding dividends, you would have earned 30 cents or 10% on your \$3 investment, and that is a decent return. On the other hand, if one stock rises 50% to \$1.50, one falls 50% to 50 cents and one remains flat at \$1, you would just break even, earning no return at all on your money. So managing risk is almost more important than anything else you do in generating positive returns over the long term.

Be Diversified

Every market cycle has its own leadership, which rarely repeats from cycle to cycle and which can be dangerous to follow if you come in late in the cycle. That is why we try to build a diversified portfolio that blends offensive and defensive positions, rather than concentrating on just two or three of today's hot sectors that may fall from favor tomorrow. For example, investors who focused exclusively on technology, telecom and dot-com stocks in the last cycle found they had no defense when those sectors crumbled.

Know Your Sleeping Point

Whenever you start to feel squeamish or nervous, whether in bear markets or otherwise, you should sell to the sleeping point. If you are constantly worried about your portfolio, you will make bad decisions. Of course, people have different tolerances for risk. Some investors thrive on risk and some cannot

handle any. We have always tried to invest for all kinds of weather because we are perpetual investors. Having an "all-weather" approach to value investing is the best way we know to manage risk and potentially keep growth compounding over the long term ahead of the market as a whole.

Many market studies show, and we would not disagree, that keeping 65–70% of your portfolio in equities should be enough to satisfy most investors' long-term goals. Life is full of unpredictable changes, as we have seen with the tragic events of September 11th and the bursting of the market bubble. Having some of your money in cash or bonds allows you to live through bad markets without panic. Looked at another way, if you keep at least three years of living expenses in reserves outside of the stock market, as financial experts often advise, you are less likely to feel undue pressure even during a prolonged downturn.

Ironically, the cash you have outside the market seems just as valuable when that cash is yielding 1% or less, which is the case today, as cash does when it is yielding 12% or more, which was the case 20 or so years ago. The rate of return you earn on your cash is not important. What counts is having that cash as a buffer so you can sleep better, reason better and stick with your long-term strategy. We know of no better way to build wealth over the long term than to stay invested with a diversified portfolio of equities.

For more information, please contact...

DAVIS DISTRIBUTORS, LLC
2949 East Elvira Road, Suite 101
Tucson, AZ 85706
1-800-243-1575

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