Fair play

Century Management's Arnold Van Den Berg has built a spectacular track record of performance over the past 40 years, by placing his bets based on the fair value of stocks, relative to bonds and historic valuation bands

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Value works! That is one of the first lessons you learn from Arnold Van Den Berg's 41-year-long investing career. A $10,000 investment in Century Management Investment Counselors' CM Value 1 Composite, founded by Van Den Berg in 1974, would have made you 80.25 times richer today (as of September 30, 2009), that's $802,500 as compared to the S&P 500's $481,239 and Dow Jones's $522,355.

Born in Holland in 1939, Van Den Berg survived the Nazis and World War II along with his elder brother, when both of them were smuggled into an orphanage during the War. He was only three years old then. After the war ended, Van Den Berg moved with his family to the US. He went to high school and after completing his education took up a securities salesman job at a mutual fund company, Capital Research in 1968. But he set his ambitions higher – Van Den Berg wanted to run his own investment company and in 1974 he founded Century Management, grounded on the value principles espoused by Benjamin Graham. The performance of his funds is evidence of the soundness of the value approach that he ardently follows till date.

Van Den Berg invests his money in stocks only when the reward-to-risk ratio is in his favour. Today, he describes the US market "above fair value" where "bargains are hard to find". In consonance, cash is now the largest position in his portfolio at 23.5 per cent. A stand he defends in his most recent newsletter: "When we see that these assets (stocks) are above our fundamental buy points, and the ratio of upside potential versus the downside risk is not in our favor, we will invest in cash and cash equivalent holdings irrespective of the short term yield".

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This is not the first time Van Den Berg has been long on cash. He had been warning of an impending bubble in asset prices since 2004. "If past bubbles are any indication, the aftermath of this one will be doozy," he had said then.

The crash, as we all now know, eventually came three years later in 2007. But Van Den Berg does not overly concern himself with the ever puzzling question we are so fond of occupying ourselves with: Are we in a bull market or are we in a bear market? He invests when he finds value in individual stocks. Period.

Van Den Berg talked to *Outlook Profit* about the markets, when he buys stocks and when he prefers bonds. He also recommends some books which, he says, have had a major influence on his life and could benefit others also.

How do you view the markets today?

We believe that relative to company fundamentals, interest rates, and inflation, and with the potential for growth, the average stock in the US market is now approaching the upper-end of its fair value zone. We define fair value as the midpoint between the buy and sell point. Over our 35 years in business, one of the best ways we have found to measure whether the US equity market as a whole is cheap or expensive, is to study the relationship between the Moody's Baa (investment grade) corporate bond yield and the median (mid-point) P/E of the 1,700 stocks found in the Value Line Investment Survey. Throughout this time we have watched this relationship weekly and found it to be an excellent proxy for the average stock. The reason this relationship is important is because stocks and bonds are always in competition for investor dollars, so monitoring this relationship helps us to arrive at what we would consider to be the best fair value P/E ratio, given the current interest rate environment.

Today, the Moody's Baa corporate bond yield is at 6.23 per cent, which would suggest a fair value P/E of 20. However, the 65-year average Baa bond yield is 7.50 per cent, which is equivalent to a 16.67 fair value P/E. While it's more conservative, we think in today's environment we are better off using the long-term average as it helps to smooth over market extremes. In other words, it helps prevent us from using P/E ratios and other valuation standards and assumptions that might not be sustainable in the future. Remember, a year ago the bond yield shot up to 9.49 per cent and today it is 6.23 per cent!

Over the past couple of weeks the Value Line median P/E has ranged between 17 and 17.5 and the Baa yield has ranged between 6.11 per cent and 6.35 per cent. So we believe that just on today's numbers there is still some upside in the market, maybe as much as 30 per cent over the next 12 to 18 months. But that is on today's numbers. If we normalise the yield and use the long-term average, the US equity market as a whole is closer to the upper end of its fair value and on this basis we believe it has just 5 per cent to 13 per cent upside.

Why use the median P/E and not the average market P/E for your analysis?

There are several reasons why we like to use the Value Line median P/E versus an average market P/E. First, Value Line uses two quarters of forward earnings and two quarters of

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trailing earnings. The average market P/E in the S&P 500, for example, uses four quarters of forward looking earnings. Thus, using the median P/E helps to reduce the risk of errors when making projections. The second reason we like using the Value Line median P/E versus an average market P/E is that average market P/E can be distorted. For example, in 1998 the S&P 500 was up 28.5 per cent. While more than 50 per cent of the stocks in the S&P 500 were down that year, 10 of the largest stocks in the index were up so much, that they represented 77.1 per cent of the S&P's total return of 28.5 per cent. Therefore, using a median P/E we have a much better idea of what the P/E is for the average stock.

So is this a good time to buy stocks?
All that depends on the reward-to-risk ratios that you are looking for. Our favourite ratio is 5 to 1 — in other words, $5 of upside for every $1 of risk. Over the past 35 years, we

have found that when you have a basket of 30 to 40 stocks with 5 to 1 odds in your favour, you're going to have a very good performance over the long run. On the larger, blue chip stocks, in most cases the best you can typically get are 2.5 or 3 to 1 odds. This recent bear market has been an exception, but most of the time this is the case. But on those smaller to mid-size companies, you really want to hold out for those 5 to 1 odds and in some cases, if you're patient, you can get even more.

As far as today's overall market, if we use the Baa yield of 6.23 per cent, we believe the odds are roughly $1.5 or $2 of upside for every $1 of risk. However, if we use a more normalised 7.50 per cent Baa yield, the odds are reversed — for every $1 of reward you have $3 to $4 dollars of risk. Either way you look at it, the US equity market as a whole is above fair value and bargains are hard to find. However, this is the market as a whole. Even in this environment, if you look at individual companies, as we do, you are sure to find at least a few values that give you the 4 or 5 to 1 odds.

So what do you do if you don't find enough values to get fully invested?
We hold cash or short-term US Treasuries. Regardless of yield, when investments are absent of value, cash is always a better option than permanently losing money. Think of it this way. If we sit in cash and wait for a $15 stock to get down to our $10 buy point, then when it eventually goes back up to $15, we get a 50 per cent return on our investment. We think this more than makes up for the few months or quarters we might have to wait in cash, even if cash paid no yield at all.

So if you are always comparing stocks and bonds, when do you decide to go into bonds?
In short, when we can get a 3.5 per cent to 4 per cent real rate of return (above inflation), we believe bonds are selling at a pretty good value. Typically, we invest in US Treasuries and US corporate bonds. Over the last couple of years, we have had opportunities to buy both in our balanced and fixed income portfolios.

Let me give you one example regarding corporate bonds. Over the past 47 years, the normal spread between the Moody's Baa bond yield over the 10-year US Treasury bond yield has been 193 basis points, or 1.93 per cent. Only in two periods, since 1962, did this spread widen to 350 basis points, or 3.50 per cent — they were 1980-1981 and 2001-2002. Both were outstanding buying opportunities for investment grade corporate bonds. So in the fourth quarter of 2008, when the spread widened to 617 basis points (6.17 per cent), we took full advantage of this opportunity — we sold our long-term US Treasury bonds and reinvested the majority of these proceeds and more into a basket of US corporate bonds. At that time the Baa bond yield peaked at 9.49 per cent. For those investors that were looking for value in bonds, that was a great opportunity. The average investment grade bond today yields 6.23 per cent. With headline CPI inflation at 1.5 per cent, this is a 4.7 per cent real rate of return. So, overall, most bonds are still a good value today.

Coming back to stocks, if you can find good value even in an expensive market, would you still go ahead and buy?
We believe that if a market is so overvalued that you can only find a few stocks to buy, you are probably better off not buying anything. Let me give you an example. Typically we like to have an inventory of approximately 300 stocks where we have done our work and are ready to go; we are just waiting for the right price. Well, in 1987, in the months just preceding the historic October crash, we only found about 13 stocks that were of value. And then in one day, the Dow Jones Industrial Average dropped 22 per cent, and over 266 stocks out of the 300 on our inventory list became a buy.

So our advice is that when your inventory of ideas selling at value prices begins to shrink dramatically, you are probably better off just holding cash. And if history is any indication, once a market really reaches that heated or manic phase, you will only have to wait a short time until you get some wonderful buying opportunities.

Are we in a new bull market now as many people claim?
We don't know — all we go by is how cheap individual stocks are. Different people have different labels that they put on

the stock market to describe whether it's in a bull market or bear market, and in today's environment there is no shortage of opinions as to where it's going. But as far as we're concerned, when stocks are cheap it's a bull market, and when they're expensive it's a bear market. It doesn't matter to us what you call it as long as we can buy stocks that can double in 3 to 5 years while having a margin of safety.

What is your buy level in terms of price/sales (P/S), an indicator that you have often been credited for looking at?
On October 13, 2009, the total US equity market was selling at 108 per cent of sales. Now this is on the US equity market as a whole, so it could be a lot lower on individual stocks. But in general, if we go back and look at the total market price as a percentage of gross domestic product (GDP), we can create a price-to-sales ratio on the entire US equity market. On average, over the past 85 years, the US equity market has sold at 76 per cent of sales. It hit an all-time high of 186 per cent of sales in March 2000 and a low of 35 per cent of sales in June 1982. The low in this bear market was 77 per cent of sales on March 31, 2009. Considering the interest rate environment, a good price-to-sales ratio to use for a buy point would be anywhere between 70 per cent to 80 per cent of sales.

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Moving to commodities, what's your view on gold?
I have been a student of gold going back to the early 1970s. As a matter of fact, when we started Century Management, one of the investments we did very well with was gold. However, today, we don't have a strong opinion about gold one way or the other. We are not investing in it nor do we have plans to, at this time.

If we thought we were going to have a real economic debacle, worse than the one we've already had, we might consider buying gold, but we don't think we're in that situation today. Based on its own supply and demand fundamentals, we don't believe that gold is cheap today. Furthermore, on a reward-to-risk basis, we think there are greater opportunities today than gold — especially at these prices. Now, if we believed that we are going to have runaway inflation, we would be a buyer of gold, but again, we don't believe this is likely to happen anytime soon. If anything, the big problem today is deflation, not inflation.

How do you approach commodity companies?
Unlike your average consumer or industrial company, where we can put more weight on free cash flow, we would put more weight on book value in a commodity company because cash flows fluctuate so widely. Another way, is to look at the value of their facilities. For example, in the case of a steel company you need to find out the value of its production facility and how much it trades for in an up-market and in a down-market. Or if you are looking at an oil company, look at the value of the reserves. Then you take this information and look to see what these stocks and their relevant ratios, facilities, and reserves traded for when the stocks were cheap and when they were expensive. When you complete this exercise you will get a pretty good idea of what the stock is worth.

For example, if you were to take a commodity company and look at the yearly high and low price-to-book ratio that the stock has sold for over the past 25 to 30 years, and then calculate the average and median price-to-book ratio for all the low years and then do the same for the high years, you will get a pretty good idea of just how cheap and expensive the stock can get. When you repeat this exercise with the other relevant ratios and valuation standards that are specific to the industry or company you are looking at, you can arrive at some fairly accurate valuation price points. Now there are times that extreme high prices or ratios should be removed from the averaging so they do not distort a more normal upside picture. However, due to our more conservative nature we have found it important and would recommend to you to always include all low price points in your averaging.

Last, a good rule of thumb when it comes to commodities is that you buy surplus and you sell scarcity. For example, when the price of oil was real high there was a scarcity, so it was time to sell. In other words, whenever there is a shortage, the price goes up and people can't see that shortages don't last so it is time to sell. And whenever there is a surplus of the commodity and companies are losing money, everybody thinks they are never going to recover. This is the time that the shares are selling at a discount to book, and that's when you buy them.

What books would you recommend to our readers?
Well, first we would recommend they read *The Intelligent Investor*. We also think going back and reading Berkshire Hathaway's annual reports is worth the time (they are on the Berkshire website). The late Philip Fisher wrote several books that are very good, *Common Stocks and Uncommon Profits*, *Conservative Investors Sleep Well*, and *Developing an Investment Philosophy*. Seth Klarman's *Margin of Safety: Risk-Averse Value Investing Strategies for the Thoughtful Investor* is a good book about risk. An easy but good read for those just getting started would be *Value Investing Made Easy* by Janet Lowe. Then there is Roger Lowenstein's *When Genius Failed: The Rise and Fall of Long-Term Capital Management*. There are some real good lessons in that book. And for a more in-depth understanding, lifetime study, and reference is *Security Analysis* by Benjamin Graham and David Dodd.

Philosophically, I would like to recommend several books that have had a major influence on my life. They are written by James Allen who is my favorite author on the subject. They are *From Poverty to Power*, *Eight Pillars of Prosperity* and *As a Man Thinketh*. Each of these books has tremendous lifetime principles – you have to read these books over and over and each time you do, you will get more out of them. I've been reading James Allen's *From Poverty to Power* for more than 30 years now. It's only after you experience something that you can go back and say "Oh! Now I understand this!", so I prefer to read his and other good books many times over rather than just reading more books that don't seem to add more than the original great works. ◻