Extreme Value Newsletter

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THE BLAST: What Great Investors Say... and What They Do With Real Money
By Dan Ferris

"Trees don't grow to the sky, and the world has a way of not coming to an end."

I wrote those words in this column several months ago. "Trees don't grow to the sky," means that stocks don't go up forever without a correction. "The world has a way of not coming to an end," means that you should never be afraid to invest in a safe, cheap stock just because you think the overall market is overpriced or will soon fall.

You can see these two complementary sentiments at work in the minds of the most successful investors.

Take Warren Buffett's dire warnings about the U.S. trade deficit. They've become a regular feature on the investment landscape. He even wrote a big piece in Fortune magazine about Thriftville (Asia) and Squanderville (the U.S.), and how the U.S. is transferring its wealth overseas.

And yet, Buffett – since buying $19 billion in foreign currencies and sounding warning bells about the U.S. economy – has bought shares of Pier One Imports, Comcast, and ServiceMaster.

How bad does he think it's going to get if he's buying Comcast and ServiceMaster? I don't know about you, but if I were in dire financial straits, cable TV and ServiceMaster's Chemlawn treatments would be the first things to disappear from my budget. I never go to Pier One to begin with, and probably never will.

Arnold Van Den Berg of Century Management provides us with another good example of someone who warns us that trees don't grow to the sky, and puts money to work as if he's certain the world will not come to an end. Van Den Berg recently sent me a 65-page report that detailed his concerns about the U.S. equity markets.

Van Den Berg pays attention to the overall value of the stock market versus the value of the U.S. economy as a whole, measured by U.S. Gross Domestic Product. That's like a price-to-sales ratio for the entire

U.S. economy. Buffett has discussed the importance of those numbers before. The price-to-sales ratio for the entire U.S. economy has averaged 76% over the last 40 years. That is, on average, all the U.S. stocks together have been valued about 24% below the U.S. Gross Domestic Product, over the last 40 years.

Today all the U.S. stocks together are selling for 36% more than the value of the U.S. economy. The stock market is valued higher than the whole country's economic output. Van Den Berg also worries about high levels of corporate and personal debt in the U.S. today.

It's not hard to see why he's been holding 65% of his and his clients' money in cash (as of 9/30/04). Mind you, this is the guy who was holding reams of cash just before the market crashed in 1987. He started buying 45 minutes before the close on the day of the crash and made his clients a bundle of money by doing so. When he says it's time to hold cash, it pays to listen.

And yet, Van Den Berg has also said, "I'll buy any stock anywhere, any time… as long as it's a bargain. We don't care about the market."

I take the warnings of these wizened, and highly successful men to heart. I recommend that you do the same. And, looking at Van Den Berg's huge cash position, Buffett's huge cash position and his large position in foreign currencies, I see that, overall, their money is mostly where their mouths are. But you and I both know that, if a stock they like gets cheap, the trade deficit and record debt levels won't stop them from buying as much as they can get their hands on.

I also note other highly successful value-oriented types complaining about finding opportunity. Longleaf Partners got so tired of not finding enough opportunity that they took their managers on a two-day retreat to strengthen research efforts and keep the big returns coming. Longleaf's 2004 year-end report contains a laundry list of warnings about U.S. stocks and the U.S. economy. They're warning investors about historically low interest rates, low stock price volatility, high stock prices, highly bullish sentiment among newsletter writers and levels of insider selling not seen since 2000.

Just as you'd expect, Longleaf's Partners Fund is holding plenty of cash, 27% of assets under management. And yet, after all their dire warnings, Longleaf goes out and buys a huge position in – of all stocks – General Motors. They say that GMAC, the finance unit, is worth more than the whole company is trading for today. I'd like to think I've got a contrarian streak a mile wide, but even I won't touch GM.

As for my own experience, I attended the World Money Show in Orlando two weeks ago. Every financial adviser with a book or newsletter to sell was there. Many publicly traded companies were there. Several money managers looking for new clients were on hand, too. And several financial publishers like Dow Jones and Forbes were also there.

As I walked through the exhibit hall, and sat in on several presentations, I noticed something. It was plain as day for anyone who bothered to look. Everyone at that event was squarely focused on a single idea: making big profits through short-term trading. The message is obvious. When the short term looks like a great bet to the overwhelming majority of investors, you can bet that lots of people are going to lose money in the short term – the next 12-18 months.

It also tells me that doing what Buffett, Van Den Berg, and Longleaf do – buying value and holding long term – is an excellent way to get an advantage over probably 99% of all other investors in the market.

The latter course is the one we advocate and practice in the pages of Extreme Value each month. We buy the cheapest, safest stocks we can find and hold them for the long term.

I expect that some great bargains will be created over the next several months, as the short-term chickens come home to roost. In the meantime, whenever I find a stock that's safe and cheap, I'll add it to the Extreme Value Model Portfolio, no matter what the overall market looks like.

Good Investing,

Dan Ferris