

Active Value Investing

*Making Money in
Range-Bound Markets*

VITALIY N. KATSENELSON



John Wiley & Sons, Inc.

More Praise for **Active Value Investing**

“Whether a self-styled seat-of-the-pants day trader or the kind of investor who intends to buy and hold forever, you’re operating at a distinct disadvantage if you lack the skills to break a company down into its financial nuts and bolts. Vitaliy “Red” Katsenelson is one of the best on the Street at analyzing a business and putting that knowledge to work to make money. In *Active Value Investing*, Red shares the skills and strategies that allow him to cut through the noise and build a long-term portfolio of winners. Bull and bear markets come and go, but the ‘secrets’ shared in this book are forever. This book is a must-have guide for any market!”

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and CNBC’s *Fast Money*

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—Thomas K. Brown
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Active Value Investing

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

Wiley Bicentennial logo: Richard J. Pacifico.

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Library of Congress Cataloging-in-Publication Data:

Katsenelson, Vitaliy N.

Active value investing : making money in range-bound markets / by Vitaliy N. Katsenelson.
p. cm. – (Wiley finance series)

Includes bibliographical references.

ISBN 978-0-470-05315-7 (cloth)

1. Speculation. 2. Investments. I. Title.

HG6041.K36 2007

332.6–dc22

2007013701

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

*For my parents:
My father Naum and in memory of my mom Irene
Thank you for always believing in me*

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Preface

Readers of investment books are right to be skeptical. Hundreds of new titles hit the shelves of bookstores every year. It is hard to navigate them and determine which are worthy reads and which undeservingly consume bookshelf space.

I wrote this book for skeptics who look for opportunity but have a healthy dose of “the glass is half empty” mentality and a great passion for investing. Whether you are an “I’d rather do it myself, damn it!” investing weekend warrior or an “I do it 12 hours a day and eat lunch at my desk—I love this job!” professional investor (the latter category is where I fit in), you should find this book worthwhile. It takes common and traditional investing concepts and modifies and applies them in some surprising and profitable ways to the enigma of the range-bound market.

If you properly take the role of a skeptical reader, I’ll answer questions you’d want to ask me before you buy this book.

Skeptical Reader: How is *active* value investing different from just value investing?

Vitaliy Katsenelson: *Active* value investing is the necessary modification for traditional value investing strategies to make them effective in range-bound markets. Although principles of fundamental analysis are agnostic to the long-term direction of the market, stock analysis and investment strategy should be *actively recalibrated* to adapt to changing market environments.

SR: What are these “range-bound markets” you’re talking about?

VK: The most vivid analogy is to a roller coaster. After all the excitement of dramatic up, down, sideways, and pin-your-back-to-your-seat thrill-ride gyrations, no matter how long the ride lasts, you (and your portfolio) end up back where you started. This is the fate of the *inactive* value investor, the buy-and-hold and passive index investor, during range-bound markets—close to zero stock returns plus meager dividends, with time having passed but little progress toward retirement nest-egg goals.

SR: This is a bear market, then?

VK: On the surface that certainly seems how it appears, but this is a common misconception. We are used to thinking about markets in binary terms: bull and bear. But if you look at the U.S. stock market during the entire twentieth century, most of the prolonged (greater than five years) markets were actually bull or range-bound markets. Prolonged bear (declining) markets happened in the past only when high market valuation was coupled with significant economic deterioration, similar to what was going on in Japan from the late 1980s through 2003 or so.

SR: And you think we are in one of those range-bound markets?

VK: Yes. If two centuries of stock market history are a guide, every protracted bull market (and we just had one of those from 1982 to 2000) was followed by a long-lasting range-bound market. Range-bound markets are the payback times—investors are paying with their returns and with lost time for the valuation excesses of prior bull markets.

SR: I see the first part of the book is entitled “What the Future Holds.” That doesn’t sound like value investing to me. What’s that about?

VK: This book is a practical guide to value investing in range-bound markets. But to buy into and incorporate these strategies into your own investing process will require some convincing. I know I would need to be convinced. Therefore, in the first part of the book we examine historical performance of the U.S. market over the past two centuries and discuss what caused prolonged bull, bear, and range-bound markets. We look at the emotions that have dominated each of these markets, and why there is a high probability that a range-bound market has descended upon us and is here to stay for another good dozen years.

I’ll then provide a framework that will help you forecast how long this market will last, and explain why I believe that corporate earnings growth over the next several years will lag gross domestic product (GDP) growth.

SR: If the market is not going anywhere, just up and down and sideways, you’ll probably just tell me that I need to become a market timer.

VK: I won’t. I promise. And what I do instead is offer a major new alternative mind-set. It is hard, if not impossible, to create a successful market-timing process. A market timer’s buy and sell decisions are made based on predicting the short-term direction of

stock prices, interest rates, or the condition of the economy. Aside from the fact that this demands that you be correct twice—when you buy and when you sell—emotions are in the driver’s seat of the market, especially at the tops and bottoms. You don’t need to time the market; you need to time the valuations of individual stocks.

SR: You are saying don’t time the market, time stocks. How is that different from timing the market?

VK: Timing stocks is not much different from what you are accustomed to doing, except it has to be more proactive. If you don’t like the word *timing*, call it *pricing*—you need to price individual stocks. Then you actively engage in a strategy that helps you buy when they are undervalued and sell when they approach becoming fully valued. As a market timer your cash balance is a function of what you think the market is about to do. However, the stock timer’s (pricer’s) cash balance is a by-product of investment opportunities you see in the market.

SR: I hope you are not saying that I need to be a day trader!

VK: Not at all. But you need to be a more active investor during range-bound markets than in a pleasant bull run. The traditional buy-and-hold strategy of the last bull market is not dead, but close—it is in a coma.

Buy-and-hold is really just a code name for the “buy and forget to sell” strategy. A stock is usually *bought* with a discipline, but *hold* is really just a disguise for absence of a concrete sell discipline—unless you call “I’ll own it until death do us part” a discipline. “Buy and forget to sell” works great in a prolonged bull market, when P/Es keep expanding from much below to much above average; stocks of so-so companies rise, and stocks of great companies shoot to the stars. Passive investing—buying and never selling—is rewarded.

The opposite takes place during a range-bound market, as P/Es go from much above to much below average (it happened every single time during the twentieth century). We need a new thinking paradigm to replace what we subconsciously learned in 1982–2000!

SR: And you’ll tell me what to do, right?

VK: Definitely. In Part II, the practical application section of the book, we discuss stock analysis and active investing strategy for range-bound markets.

In the Analytics section, we discuss a Quality, Valuation, and Growth (QVG) framework that lies at the core of the approach, and which should add clarity to stock analysis. We look at a stock from

this systematic, three-dimensional view and assess each dimension separately; we then explore interactions among them. We identify what constitutes a good company, and how to determine at what price these good companies turn into good stocks worth owning.

The Quality and Growth dimensions of the analysis require some tweaking in range-bound markets, but it's not that much different from any market analysis. The Valuation dimension, however, requires the most recalibration for the range-bound markets.

SR: Why Valuation?

VK: Constant P/E compression, a staple of range-bound markets, requires a good understanding of stock valuation and a reassessment of valuation tools. Relative valuation tools generate false buy signals in times like this and should be used only in conjunction with absolute valuation tools. Absolute valuation becomes increasingly important in range-bound markets, however; this is discussed here in depth, and I introduce some new tools.

SR: What if I am a growth investor—do I care about all this?

VK: You very much should! Throughout prolonged range-bound markets, investors are willing to pay progressively less for earnings growth. P/Es of higher-growth companies contract at a much faster rate for higher-valuation stocks than for low-P/E stocks. I performed a study of what happened to low- and high-P/E stocks throughout the 1966–1982 range-bound market. In the beginning, investors were willing to pay a 200 percent P/E premium for high-growth companies versus low-growth companies. However, that premium consistently shrank, ending up at only 40 percent by the end in 1982. Growth investors must understand this dynamic to navigate these markets.

SR: But the higher earnings growth rate of growth stocks overcompensated for P/E compression, right?

VK: Not at all! Low-P/E stocks outperformed high-P/E stocks on a consistent basis throughout the 1966–1982 range-bound market.

SR: What if I'm a growth investor—what do I do about this?

VK: Be absolutely sure that the earnings growth and dividends of the higher-P/E stocks will overcompensate for their likely P/E compression. In the Valuation chapter I provide several adjustments that will help you deal with that.

SR: Does your strategy change as the market evolves?

VK: You need to *become an active buy-and-sell investor*. I cannot overemphasize the importance of the selling process. You need to

sell when your stocks hit their predetermined sell valuations, which will be emotionally difficult, since often it will happen when everybody else is buying and excited about the market again. I'll share some strategies that will help you become a better seller.

This brings us to the importance of *being an independent thinker, a contrarian*. In fact, it is so important that I dedicated a chapter to contrarian strategies: taking advantage of media myth amplification, time arbitrage, how to use myth busting to find undervalued stocks, generate new stock ideas, and more.

It is more difficult to invest during the trendless range-bound market than in the bull market; no question about it. So a look overseas at other markets should help you to increase the incremental opportunity cost of each decision. This is the subject of Chapter 11.

SR: Amen! But what if I don't buy your range-bound market argument?

VK: Although I've written this book specifically to address investing in such markets, a lot of the concepts discussed have solid application at other times as well. In fact, I use the concepts from these sections (minus modifications for the range-bound markets) to teach Practical Equity Analysis class at the graduate school of the University of Colorado at Denver. I also added two chapters, "A Different View of Diversification" and "A Different View of Risk," in the Risk and Diversification section that apply to analysis in any market.

SR: What if the range-bound market you describe is not in the cards and we'll have a prolonged bull or bear market instead?

VK: Every strategy should be evaluated not just on a "benefit of being right" basis, but at least as importantly on a "cost of being wrong" basis, and I intend to do just that. The Active Value Investing strategy has the lowest cost of being wrong! It is superior to buy-and-hold or high-growth strategies in the range-bound and bear markets. In a very unlikely case of a full-fledged prolonged bull market, Active Value Investing should provide strong returns but may underperform buy-and-hold and high-beta strategies. The small level of underperformance is a reasonable insurance premium to pay to avoid failure in a range-bound or bear market.

SR: If what you are describing is true, why shouldn't I just buy bonds?

VK: Again, approaching strategies on a "cost of being wrong" basis, the Active Value Investing strategy should outperform bonds in a bull market, in a range-bound market, and in a bear market caused by or coinciding with inflation. The only time bonds will do better than

stocks is if the U.S. economy goes into a severe deflation-caused recession. And even in this case government default-free bonds should do comparatively well, whereas corporate bonds' performance would be questionable as their default rates are likely to skyrocket.

SR: Is this an academic book?

VK: No. I have little patience for academic investment books that are riddled with Greek symbols, heavy footnotes, and long formulas. This is not one of those books. Though we look at some formulas, I promise no Greek symbols, and the formulas will be simple enough for a seven-year-old to understand.

I'll also be sensitive to the fact that finance talk can rival the dryness of the Sahara. I've learned in my years of teaching investments that when students start bringing six-packs of double-shot espresso to my lectures I am doing something wrong. I'll attempt to make the journey as concise and as interesting as possible, keeping humor to the maximum and interjecting as many real-life, practical examples as my editor allows me to keep.

SR: Looking at your bio, I cannot figure out who you are: teacher, writer, or investor. Pick one.

VK: If I had to pick just one, I'd say investor. I love investing. I love everything about it: the uncertainty of every decision. The intellectual exercise of putting different pieces of the puzzle together while never having enough information at your disposal. The constant battle with one's emotions—the hardest and the most important battle of all. The never-ending pursuit of perfection despite its unattainability, how just when you think you have figured it out, the market has a new lesson in store for you. The humbling aspect of the market—arguably the most humbling mechanism ever invented by humans. The people, the debate, the search for the truth. The fact that for every trade there are two opposing sides (buyer and seller), and time is the variable that separates them from discovering who was right and who was wrong. And finally, the hidden, rarely recognized, but fascinating impact that randomness plays in many outcomes.

I discovered that I wanted to invest for a living when I was a sophomore in college, so both my undergraduate and graduate degrees were in finance. I topped them off with a Chartered Financial Analyst (CFA) designation. I invest for a living. It is my job, but actually more like a paid hobby. I've got the best job in the world!

If I did not miss my family and friends, I'd do it 24/7. (For my personal story of arrival to the United States, see pages 269–271.)

SR: But how does it tie in with teaching and writing?

VK: The university allowed me to create the curriculum for my class from scratch, so it is designed to be a practical and fun extension of my day job. Plus I have a captive audience.

SR: And writing?

VK: Several years after I started teaching, I discovered another passion—writing. I write only when I have an insight and interest in the topic, as a by-product of my investment process. I am a regular contributor to the *Financial Times* and Minyanville.com and have written articles for *Rocky Mountain News*, MarketWatch by Dow Jones, The Motley Fool, The Street.com, and RealMoney. This book, for example, is the result of my personal trifecta of investing, teaching, and writing—all focused around the same thing, really.

SR: How come there are few books that talk about the range-bound market idea? Actually, I don't see a single other one that talks about how to invest in range-bound markets!

VK: Investment books are usually written about investment strategies for bull markets. From a business perspective this makes sense. Books are published to sell, and interest in investing, and thus interest in buying books about investing, is highest when investors are making money—during a bull market. But this shortchanges you, my serious Skeptical Reader/Investor, as over long periods of time the stock market has spent as much time going nowhere as it has rising. Range-bound markets may not be as exciting or profitable to the average investor, but why be average? My hope is that you will find the fortitude to stay invested during this difficult market rather than running away to bonds or cash, and use the book as a resource to help you squeeze decent mileage out of a difficult market full of exhilarating highs and surprising lows.

PART

One

What the Future Holds

Introduction: Range-Bound Markets Happen

It is hard to make predictions, especially about the future.

—Attributed to Yogi Berra

FASTEN YOUR SEAT BELTS AND LOWER YOUR EXPECTATIONS

For the next dozen years or so the U.S. broad stock markets will be a wild roller-coaster ride. The Dow Jones Industrial Average and the S&P 500 index will go up and down (and in the process will set all-time highs and multiyear lows), stagnate, and trade in a tight range. They'll do all that, and at the end of this wild ride, when the excitement subsides and the dust settles, index investors and buy-and-hold stock collectors will find themselves not far from where they started in the first decade of this new century. And these at best minuscule returns are unacceptable!

The length, the angles, and the twists of the ride are yet to be written by history, but the ultimate long-term flat trajectory of the ride has been set by the 18-year bull market that ended in 2000. If history is any guide, until about 2020, give or take a few years, the U.S. stock market will continue to dance the range-bound foxtrot it has been dancing since the end of 2000. Welcome to the range-bound markets!

What a gloomy, unexciting way to start a book, you may say. But the cold shower of reality is needed to snap investors into a different mode of investing—not the mode that they have been conditioned to by the 1982–2000 bull market, but the state that we will discuss in depth throughout this book. I use the word *different* cautiously since it is a part of a dangerous phrase: “This time is different.” This time is *not* different!

There has been nothing different taking place in the U.S. broad market indexes since 2000 (or is likely to be taking place for another good dozen years) from what took place in the past. One just has to look back far enough, past the last secular bull 1982–2000 market, to notice it, and we will do just that.

The performance of U.S. stocks during the twentieth century overwhelmingly supports this rather bold (at first look) prediction; as demonstrated in Exhibit 1.1, every long-lasting bull market in the twentieth century has led to a stagnating, long-lasting range-bound market (the Great Depression that followed a prolonged bull market was the only exception).

LET'S IDENTIFY THE ANIMAL

According to Wikipedia, “A bull [upward-sloped] market is a prolonged period of time when prices are rising in a financial market faster than their historical average, in contrast to a bear [downward-sloped] market, which is a prolonged period of time when prices are falling.” What about markets that have a flat, horizontal trajectory? They are known to professionals as range-bound or trendless markets, and they look different from bear markets, although investors often lump them together. We'll talk about their differences in the next chapter.

Since investors are so used to associating animals with the slope of the market, I have some suggestions for range-bound market names—chicken, or sheep perhaps. Or my personal favorite, cowardly lion, whose bursts of occasional bravery lead to stock appreciation, but are ultimately overrun by fear that leads to a subsequent descent.

For those who are used to thinking of markets in the bull and bear terms and are indifferent to cowardly lions (amazingly, I've been told, some people are), may I suggest adding another type of species to their bear vocabulary—the range-bound market bear. Thus declining bear markets you may call the grizzly bear market, whereas the market that is more or less flat you may call a range-bound bear market.

SECULAR VERSUS CYCLICAL

Let's get some more definitions out of the way. We'll be using the terms *secular* and *cyclical* to describe market conditions. A secular market describes a long-lasting (more than five years) condition that takes place once in a generation or so. Cyclical conditions, in contrast, are significantly shorter market cycles that may last months or a few years.

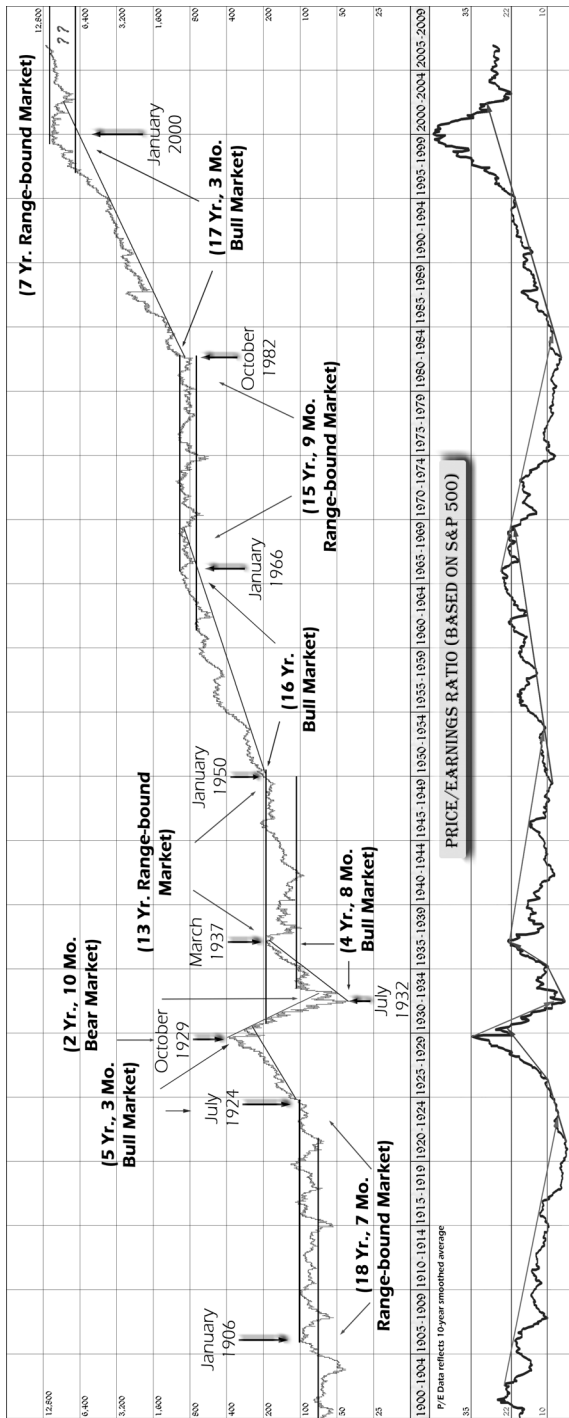


EXHIBIT 1.1 Dow Jones Industrial Average, 1900–2006

Copyright 2007, Kevin A. Tuttle, Tuttle Asset Management, LLC (www.tuttleassetmanagement.com). P/E data from Dr. Robert J. Shiller.

Investment is not an exact science like mathematics or physics, where definitions are precisely crafted. It is like economics (a dismal science) and thus definitions are often subjective and open to different interpretations. For instance, the market decline that was caused by (or some argue caused) the Great Depression, which precipitated one of the greatest drops in stock prices in U.S. history, doesn't qualify as a secular bear market according to the definition, as it lasted only two years and 10 months, less than five years as required. However, the Great Depression really was a secular bear market. (See Chapter 2 for additional information about the Great Depression.)

The long-lasting decline of the Japanese Nikkei fits well into the definition of a secular bear market, as it lasted for 13 years, starting in January 1990 and bottoming (or so it appears) in April 2003.

Since this book is focused on secular markets, when I discuss secular bull, bear, or range-bound markets, I'll refer to them just as bull, bear, and range-bound markets. I'll make sure to use the word *cyclical* when referencing cyclical markets.

DISTINCTION BETWEEN SECULAR BULL, BEAR, AND RANGE-BOUND MARKETS

Range-bound and bear markets are different in nature; the distinction is rarely made but important. Range-bound markets present unique investing opportunities and were a lot more common in the preceding century than bear markets, as Exhibit 1.1 clearly shows. Over the 100 years from 1900 to 2000, range-bound markets were occurring over half the time.

Range-bound markets are the bear markets of price-earnings (P/E) ratios (they decline), whereas bear markets are the bear markets of P/E's *and* earnings (they both decline).

Range-bound markets are so-called payback markets—investors are paying back in declining P/E's for the excess returns of the preceding bull market.

Bear markets, such as the one in Japan, are caused by a combination of excess valuation (a predominant feature of range-bound markets as well) and prolonged economic distress. High P/E's and economic distress at the same time are a lethal combination. High P/E's reflect high investor expectations from the economy. Economic blues (runaway inflation, severe deflation, subpar or negative economic or earnings growth) disappoint investors' optimistic expectations. They anticipate that the economy (and stocks) will keep performing far above average, but instead the performance is not average, but below average. The bear market has started.