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In Pursuit of Value

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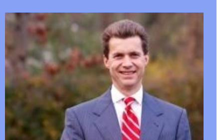
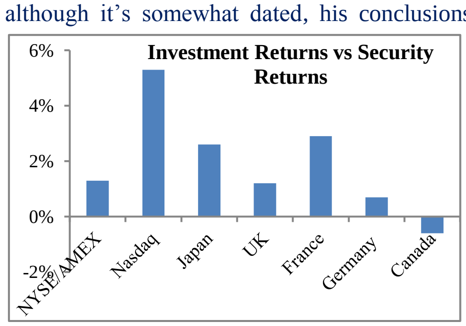


Timing is Everything

Back in the 90s when tennis had some personalities and Andre Agassi was monetizing his hip, “bad boy” image by selling Canon digital cameras, he would assert that “Image isn’t everything; it’s the only thing.” It would be only a modest overstatement to say the same of timing with respect to investing in equities. What you invest in obviously counts for a great deal, but timing matters for investors both individually and in aggregate.

Returns for securities and market indices are conventionally expressed as if $1 was invested at the beginning of the period and sold for its value at the end of the period, with dividends reinvested over time. Returns on portfolios are typically calculated to reflect timing of inflows and outflows. The difference is important; if you buy 100 shares of Hot New Stock (HNS) at $10, grin while it rises to $20 where you buy another 50 shares, and then grimace as it sinks back to $12, the return on HNS the stock is 20%, but your $2,000 investment in HNS is only worth $1,800 and has lost 10%. Unfortunate timing for one individual, but for every buyer there’s a seller and presumably in this example the investor who sold HNS did well. Just as buys and sells net out, gains and losses should too, so that in aggregate HNS investors made 20%. However, if the seller of the stock at $20 is HNS itself (i.e. it issued new shares) things become less clear. It could be that the investors overall lost out. In the above example, the *security* return on HNS was 20%, whereas the *investment* return for this investor was -10%.

Investment returns often are lower than security returns. In 2004 Ilya Dichev (now at Goizueta Business School, Emory University, Atlanta) wrote a research paper “What are stock investors’ actual historical returns? Evidence from dollar-weighted returns”, and although it’s somewhat dated, his conclusions (based on over 30 years of data) are no doubt still valid. It turns out that companies are better than you might think (and therefore, investors are correspondingly worse) at timing the market. IPOs and secondaries tend to happen at prices that suit the seller (i.e. the company raising the capital), while stock buybacks and acquisitions (by a private buyer such that they result in a delisting) generally take place at good prices for the buyer. The Nasdaq represents an acute case of the problems of market timing. From 1973-2002 returns to investors were 5.3% per annum worse than the Nasdaq index itself, a differential large enough to drive aggregate returns down to the risk free rate. The 1999-2000 market climax saw $1 trillion of new money invested through hot IPOs and secondaries. Even today that’s a lot of money. To cite another example, research done on Peter Lynch’s record during his time running the Magellan Fund found that from 1981-90 the average investor earned 13.4% annually compared with the S&P’s 16.2% and Magellan’s reported return of 21.8%. The result is that across markets and timeframes, investors do worse than the securities they invest in. The chart illustrates the difference between what investors earned and what indices returned in the six largest markets from 1973-2002 (NYSE/AMEX is 1926-2002). It’s a reliable phenomenon.



A good part of the problem is caused by investors’ efforts to time the market. It’s rarely easy, and can be very harmful to returns. Today, as on most days, the equity markets appear quite risky. There are numerous potential headwinds, currently including (in no particular order): potential gamesmanship in Congress over raising the debt ceiling; China’s efforts to combat inflation; instability in the Middle East;

high energy prices; excess debt at just about every level of government in the U.S. and in most other developed countries as well. Few could be surprised if any of these issues depress markets in the weeks ahead. Quite understandably, the “top down” or macro perspective frequently induces caution.

By contrast, it’s still possible to find interesting investments at an individual level, many of which we’ve written about in recent months (one of which is profiled below). Figuring out the near term movements of the stock market is not something we spend much time on. We’re by no means the first people to have concluded it’s too hard. Finding attractively priced investments requires hard work too, but at least the research effort can be cumulative as more time reading and networking result in (hopefully) a better understanding of the opportunity. In addition, the contrasting results illustrated by Mr. Dichev would suggest that, while timing’s important, if you don’t have any timing insight then don’t take any timing risk. Consequently, we choose what we think is the easier road: put serious thought into your asset allocations and stick with them; review them only infrequently, when circumstances change.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

What We Own

Gannett (GCI) is an old media company that’s turning into a new media one. Newspapers are by any measure a business in decline. Having read the Times and the Journal every day for decades commuting into New York, I wasn’t one of the first to make the internet my primary source of news. My children are the first generation in three centuries to start their day without a daily newspaper. Shrinking at a low single digit pace is probably the best the industry can hope for. But in addition to owning 82 daily newspapers (including USA Today) in its Publishing division, GCI also owns 23 TV stations that reach 18% of the U.S. population in its Broadcasting division and a wide variety of websites in its Digital division.

Pessimism about the newspaper industry has pressured the stock which currently trades at less than seven times next year’s earnings. Although newspaper advertising will likely shrink 3.5% this year, and Broadcasting’s year-on-year comparisons will appear weak with no Presidential election or Olympics to drive ad spending, growth in their Digital division is accelerating and by next year top line revenues should be increasing once again. They own a dizzying array of narrowly targeted websites, such as CareerBuilder, ShopLocal, PointRoll (digital marketing) and Schedule Star (a high school athletic scheduling platform). They’re also managing the conversion from newspaper to website better than most (the company notes that its USA Today newspaper layout is inspired by today’s web design). Meanwhile, the company is showing good expense discipline and is generating substantial amounts of cash. Last year they generated $773 million in operating cashflow, and with minimal capex needs they paid down over $700 million in debt. At that rate they could eliminate their $2.2 billion long term debt within three years, which might allow them to start buying back shares or even make them an acquisition target. However, with leverage of just 1.9x EBITDA, Gannett is well under the company’s debt covenant of 3.5x and doesn’t need to further reduce debt levels. Management can conservatively start returning cash to shareholders through share repurchases and increased dividends. For example, if the company decided to return all free cash flow to investors, they could retire a quarter of shares outstanding each year at current prices. Or if they decided to pay out 100% of free cash flow as dividends, they could raise the dividend from $0.64 to $3.50. At a 10% yield, GCI would trade at more than double its current $15/share while shareholders collect a large dividend. GCI is a holding in our Deep Value Strategy.