

The Babson Staff Letter



Friday, April 14, 2006

A Retrospective on Five Essential Truths

Introduction

Over the years, the Babson Staff Letter has provided readers with a window into the expertise and core values of our investment staff, offering common sense and straight-forward perspectives available in few other places. The Babson Staff Letter has been a tangible expression of the practical philosophy and “do-your-homework” approach to investing that this firm has long practiced. As capital markets and investment management progressed, from investing in stocks for dividends to investing for growth, and from investing for individuals to investing to address the complex needs of institutions, Babson Capital has changed. So too has the Babson Staff Letter.

We are now at yet another critical inflection point where capital markets, investor needs, and the geography of investment opportunity are being re-mapped. Looking out over this new investment landscape, Babson Capital con-

tinues to evolve, turning its investment focus toward the global horizon to identify compelling alternative investment opportunities in less-efficient markets.

To complement this evolution, the Babson Staff Letter will undergo a change in editorial direction. As we retool the Letter, there will be a temporary pause in the publication schedule; however, there will be no break in the commitment to Dave Babson’s fundamental investment principles and our desire to share common sense insights into an increasingly sophisticated global investment landscape. As it always has, the Babson Staff Letter will reflect the thought leadership of Babson Capital’s staff and the core identity of the firm. In the months ahead, the Babson Staff Letter will again be sharing its pearls of wisdom—we hope you will enjoy it.

On the occasion of our firm’s 60th anniversary in 2000, Brad Perry, a former President and Chairman of David L. Babson & Company and a true champion of The Babson Staff Letter, authored a letter that reflected on the close ties between our firm’s history and the history of the investment management industry. The parallels are striking. Not surprisingly, in both cases, adapting to change was a recurring theme. Yet, as the investment markets and our business evolved, Brad noted the consistent relevance of the following key principles of investing:

1. **Markets are unpredictable** and ill-suited to forecasts
2. **Long-term fundamentals** are key
3. **Investor emotion** leads to volatility
4. **Valuation discipline** should guide investment selection
5. **Perspective and patience** are rewarded

As we prepare to evolve again, this time by charting a different course for the Babson Staff Letter, we reaffirm these principles as the essential truths for our organization, and we revisit them using abstracts and paraphrases from past Staff Letters and the words and beliefs of those who authored them. We think they remain as true today as they were when originally written and serve as vital guideposts for any investor going forward.

Markets are Unpredictable

“Many things simply cannot be accurately predicted by anyone, no matter how informed or knowledgeable he is.” — David T. Wendell, 1/17/74

One of the biggest obstacles to good investment results is the tendency to place too much emphasis on the short-range outlook. At times, the majority of investors seem to believe that the whole future is wrapped up in the headlines of the day.

With all the attention it gets, however, near-term forecasting is usually not very rewarding. Most of the projections made a year ago were so wide of the mark that some economists have even stopped releasing their detailed forecasts.

There is an obvious reason why the immediate future often does not turn out the way it is supposed to. On the other hand, many individuals and institutions have achieved above-average investment results by basing their policy on long-range trends. Unlike short-term imponderables that pop up from time to time, some of these can be predicted.

Long-term Fundamentals

“By focusing attention on day-to-day, week-to-week, year-to-year, investors tend to lose sight of the fundamentals.” — David L. Babson, 7/1/63

The widespread confusion in the meaning of long-term seems to arise when judging progress by price action. In the very long run, share prices reflect the basic trends of a company's business. But over periods of weeks, months, and even several years, they may be quite inaccurate as a yardstick of the fundamentals. Even though prices fluctuate widely due to business conditions, emotional waves, etc., history shows that the underlying value—the assets, earnings-power, and dividend-paying ability of successful companies—grows at a moderate average annual rate from one period to another. In conclusion, the logical definition of “long term” is the whole span of years until the achievement of the purpose of an investment program—which is adult lifetime for most individuals, perpetual for many institutions.

“As we have said many times, stock prices swing up and down primarily because investor attitudes change from optimism to pessimism and back again.” — H. Bradlee Perry, 4/6/90

Even the investor willing to look way down the road has to realize that the world changes and the fundamental position of a company can change. So while a stock may be purchased with the objective of retaining it indefinitely, a shift in circumstances might make its sale advisable. In other words, a stock list is like an apple tree: deadwood has to be pruned in order to keep the tree healthy and productive.

Stock investing is not easy. Occasionally economic and market conditions are unfavorable for quite a while, unpredictable events occur frequently, and every so often we all get blindsided by abrupt shifts in investor psychology.

But time really is on the side of the patient equity investor. In our view, the best way to cope with most of the short-term problems and uncertainties that arise is to ignore them as much as possible, and focus on the longer-term trends of business and company growth.

“Now we face another potential war...but we will make much better investment decisions if we analyze this crisis in a long-term context, drawing on the lessons of the years.” — H. Bradlee Perry, 8/31/90

This month is significant for investors because the Iraqi takeover of Kuwait has produced the greatest uncertainty since runaway inflation and a severe recession besieged the U.S. economy in the early 1980s. The experience of the past is very helpful in appraising the implications of the Kuwait situation. And certainly the greatest benefit we have gained from half a century of investment management is learning that good investment decisions require a long-term perspective.

In September 1940, the U.S. economy was still struggling to recover from the ravages of The Great Depression, and Hitler had already overrun most of Europe. Clearly, that was a time of great uncertainty. But even then, the founders of our firm were looking down the road, trying to determine which investments would fare best if the U.S. became directly involved in the war and which would be more rewarding in the postwar economy.

Investor Emotion

“These swings in emotions can be a long-term investor’s best friend.” — David T. Wendell, 11/4/71

Psychology is the most mercurial and least predictable of all the factors which affect the short-term trend of share prices. The prevailing mood can not only shift in a matter of weeks—depending largely on how “the market is doing”—but it almost always turns out to be wrong at the highs and lows.

A national TV news program sent one of its reporters to Wall Street this week to look into why stocks were going down. At the end of his film clip, he solemnly announced that all the people he talked to expect the market to decline further—not realizing that his finding, if accurate, is actually more bullish than bearish.

Just as it’s a truism that few stocks are bargains when the vast majority of investors are highly optimistic, it’s also the case that the best values often become available during recurring bouts of pessimism.

“Once in a while the investment that no one ever wants to own again turns out to be a turkey forever,

but far more often it eventually becomes a peacock.” — H. Bradlee Perry, 7/14/95

People get manic-depressive about their investments from time to time. [Over time,] we have seen how dramatically investor psychology can shift in a flash, stimulating sharp advances and declines in security prices. Individual stocks now tend to adjust immediately, in full, to adverse news developments (and to a considerable extent, to favorable developments). Clearly, this reflects today’s instantaneous dissemination of news throughout the investment community and the very short-term focus of most institutional money managers. No longer do stocks slump gradually as investors ponder the significance of news. Instead of ready, aim, fire, it’s just fire!

When the music is playing loudly, happy or sad, and the bandwagon is rolling down the street, everyone wants to climb aboard. Whether one is dealing with bonds, growth stocks, value stocks, or whatever, a good dose of contrarianism is very helpful. When most people are panting to own an investment, it’s well to be cautious about it, and when everyone is bailing out because the current picture is gloomy, that may be the time to be a buyer, not a seller.

Valuation Discipline

“We are strong advocates of basing investment decisions on thorough studies of value rather than wasting time guessing whether prices will be higher or lower next week.” — David L. Babson, 8/27/51

The market guesser pays scant attention to the fundamental measurements of value—the relationship of price to current and prospective earnings and dividends. He has no more adequate method of analyzing the future prospects for industrial activity than a guess. The man who is more concerned with price than value places little weight on the differing characteristics of industries and companies. He assumes everyone interested in securities is a speculator.

We have attempted to point out the fundamental difference between basic value and market price. Values can be analyzed and tested by statistical measurements. While emotional factors and surprise news developments often temporarily upset the relationship between price and value, eventually the two become correlated.

“The Price Is Right may be a silly TV show, but it’s a vital factor in investing.” — H. Bradlee Perry, 9/14/01

The big game of the late 1990s was “momentum investing.” The process was simple: find companies with rapidly growing earnings and rapidly ascending stock prices and buy those shares willy-nilly because they had positive momentum.

In the real world, one does not pay a Mercedes price for a Chevrolet, a Rolls-Royce price for a Mercedes, or Learjet price for a Rolls-Royce. Similarly, the basic laws of economics tell us that any business is only worth what it can earn in profit and pay in dividends over the long run.

If a person is thinking of buying the local hardware store in his hometown, the first thing he will look at is the financial statements of the store to see how much it has been earning in profits over the years. Then he will analyze the business and try to figure out if he could increase the profits of the business under his management.

In the stock market, it’s no different. There are tried-and-true measures for determining realistic valuations of different businesses.

Perspective and Patience

“A stockholder in a large corporation should consider himself as much a part of the business as though it were a small privately-owned firm.” — David L. Babson, 1/5/53

Many clients or members of their families are owners or managers of private businesses. They understand the current problems and longer-range prospects of these companies. If they think a decline in their business may materialize, they do not rush out and sell it. Neither are they concerned in the day-to-day changes in its net worth.

Stockholders should think along with the management, consider their plans for the present and the future, the nature of the business generally and how it may or may not succeed or grow in the years ahead.

“One of the greatest mistakes investors make is to try switching from one strategy to another to make sure they are always riding the fastest horse around the track.” — H. Bradlee Perry, 4/5/91

If you keep changing approaches in an attempt to be continually in synch with what is popular in the market, you never develop enough expertise in any one of them to execute it really well. As part of the unpredictability of the market, you can rarely tell when a particular investment approach will lose momentum for a while and go out of phase with the market—or vice versa, when an approach already out of phase will come back in.

There is no single, magic formula to doing well in stocks over the long term. There are a number of sensible investment strategies and the key is to follow one of them consistently, with great discipline, because no particular investment approach works well every single year. Over the years we have observed that equity investors who own shares of strong successful companies as long-term investments, and who don't try to hop in and out of stocks with every change of the wind, are a lot calmer and more confident about their portfolios than those who are trying to time the market.

Conclusion

For our company, these five essential truths for sound investment practice have guided us over decades. In old times and in new, through changing markets and rotating business cycles, we have consistently cast a light on these truths in the pages of the Babson Staff Letter. To us, in their simplicity and timeless practicality, they represent pure investment integrity.

As we turn the page to a new chapter for the Babson Staff Letter, you can be sure that these essential truths will continue to guide our way, because like the financial markets, the more things change the more the keys to success remain the same.

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470 Atlantic Ave., Boston, MA 02210 ▪ 1500 Main Street, Springfield, MA 01115 ▪ Tel. (617) 225-3800 ▪ www.babsoncapital.com