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Q3, 2005 Quarterly Commentary

Picking Stocks: Is the "Dream Team" Always Best?

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October 7, 2005

A "Dream Team" Portfolio of Great Companies - Is finding a great company the same thing as finding a great investment? If not, should we be content to own a portfolio full of "dogs" if only the prices are low enough? An interesting article in the most recent Morningstar Stock Investor (September, 2005 issue) deals with this issue, so I will begin by quoting from it:

> "If you had invested equal amounts in the following companies five years ago, how do you think your investments would have fared?
>
> *Coca Cola (KO)*
> *Dell (DELL)*
> *General Electric (GE)*
> *Microsoft (MSFT)*
> *Wal-Mart (WMT)*
>
> Pretty impressive group of companies, no? In your portfolio you would have had a company with one of the [all time] best brands in the world, a dominant and fast-growing computer company, the world's most successful industrial company, a near-monopolistic software titan, and a behemoth of a retailer. All are bellwethers that have major advantages against their competitors, and all produce handsome cash flow and returns on capital. In other words, they all have wide - dare we say super wide – economic moats.
>
> … [A]n argument could be made that this group would make a respectable "dream team" for an investor.
>
> Unfortunately, for those who bought this group five years ago, the dream team has been a set of big losers from an investment perspective."

Dream Team Stock Performance - You can see how these companies' stocks fared over the past 5 years in Table 1. If you had invested an equal amount in each of them five years ago[1], you would have lost a cumulative 14.8% on your investment, or about minus 3.2% per year[2]. You would have done better to put your money under a mattress! Admittedly this was a tough period for the market as a whole, but this group's performance was even worse than that of

[1] The performance period begins Aug. 30, 2000 and runs through Aug. 30, 2005.

[2] All total return figures include dividends paid as well as capital gains and losses.

the S&P 500, which lost an average of 2.7% per year over the same period. And this with a portfolio of some of the very best companies in the world!

Table 1 - Dream Team Five Year Investor Total Returns

Five Years, 8/30/00 - 8/30/05, Including Dividends
$10,000 Invested in Each Stock at Start of Period

Company	Value of $10K Investment at End of Period	Cumulative Percent Gained or Lost	Annualized Total Return (%/Year)
Coca-Cola	8,760	-12.4%	-2.6%
Dell	8,860	-11.4%	-2.4%
General Electric	6,430	-35.7%	-8.5%
Microsoft	8,810	-11.9%	-2.5%
Wal-Mart	9,750	-2.5%	-0.5%
PORTFOLIO	**42,610**	**-14.8%**	**-3.2%**

Economic Performance of the Companies – So perhaps these big name companies didn't perform so well economically over this particular time period. Not so. Have a look at Table 2, which shows a couple of key indicators of company economic performance, the cumulative increases in sales and the cumulative increases in earnings per share (EPS) for each company over the five year period. You can see that all five companies actually performed quite well, thank you. Except for Coca Cola, all saw sales increase between 46% and 102%. And all saw earning per share increase between 45% and 108%, with Coke checking in with a nifty 106% increase. And yet as investments all five companies' stock suffered losses over the five year period, even accounting for the nice dividends some of them paid.

Table 2 - Company Economic Performance

Five Years, 8/30/00 - 8/30/05, Including Dividends
$10,000 Invested in Each Stock at Start of Period

Company	Cumulative Change in Sales Revenues	Change in Earnings Per Share (EPS)	Cumulative Five Year Investor Return
Coca-Cola	13%	106%	-12.4%
Dell	102%	108%	-11.4%
General Electric	46%	60%	-35.7%
Microsoft	98%	45%	-11.9%
Wal-Mart	76%	108%	-2.5%
PORTFOLIO AVG	**67%**	**85%**	**-14.8%**

The Importance of Buying Cheaply - By now you may have guessed the problem. It is the price we would have had to pay for these great companies at the beginning of the period. No matter how great a company is and will be in the future, if we pay too much for it we will not do very well as investors. As I have said many times, the most important rule in my approach to stock investing is *the price always matters*[3].

Have a look at Table 3 which shows the price-earnings (PE) ratios of the Dream Team stocks five years ago, as well as now.[4] The PE ratio is for sure not a complete indicator of a stock's valuation, but it is an important piece of the puzzle, and it is enough to clearly spotlight the problem here. The average Dream Team stock's PE ratio at the beginning of the period was an astronomical 54, compared to a much more reasonable value of only 23 now[5]. For comparison, the current trailing PE of the S&P 500 is about 17.[6]

Table 3 - Price Earnings Ratios for Dream Team*

PE for Trailing 12 Months - Now and 5 Years Ago

Company	Trailing PE Start of Period 8/30/2000	Trailing PE End of Period 8/30/2005
Coca-Cola	83.5	22.1
Dell	58.7	27.9
General Electric	49.4	20.3
Microsoft	41.2	26.4
Wal-Mart	35.4	17.8
PORTFOLIO	**53.6**	**22.9**

* From p.16 of Morningstar Stock Investor, Sept, 2005

If a stock's PE ratio, which in effect is its normalized price, drops from 54 to 23, then we would need an increase in earnings per share of 135% just to break even on the investment over that period.[7] This represents a growth rate in earnings per share (EPS) of almost 16% per year *after inflation*. For comparison, the long term average *real* EPS growth for publicly traded U.S. companies has been only about 2% per year. Some periods have been better than others, but the best 20 year rolling period in the history of the stock market going back to the year 1893 saw a market average real growth rate of only 6% per year.

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[3] This may seem obvious, but it is not the norm in all popular stock picking approaches. Approaches that rely on relative strength or momentum often buy the most over-priced stocks, based on the notion that they will get even higher priced and that the investor can get out before reality sets in. Some growth stock managers claim that a stock's price is important to them, but they are able to justify almost any current price for a stock they like by predicting the long term continuation of super high growth rates. Part of assessing a stock's fair value should be a healthy dose of skepticism about projecting super normal growth rates too far into the future.

[4] "Now" means 8/30/05 in this paper when referring to any stock data.

[5] Because the data in the Stock Investor article was based on 8/30/05 data, the term "now" in this article always applies to 8/30/05.

[6] The average PE for the US stock market over the last 80 years or so has been about 15. The current value of 17 is not necessarily out of line, however, because the "right" PE ratio depends, among other things, on long term interest rates – the lower they are, the higher the PE ratio. And of course, current long term interest rates remain lower than their historical average.

[7] That's because a stock's price is simply the product of its PE ratio times its EPS. This is by definition, not by derivation.

So this is the kind of rosy future that was already built in to the Dream Team stock prices five years ago. *Just to break even* over the next five years, these stocks had to increase earnings at almost triple the rate of the best performing time period in the history of the stock market. They didn't make it!

Introducing the B Team - You might wonder, even if this roster of Dream Team stocks performed poorly as investments over the past five years, didn't they still do better than the lesser lights within their own industries? The answer is "not necessarily". I looked within each of these five companies' industries and selected a competitor within the same industry in each case that is a pretty good company, but not of the super blue chip quality of our original five. It's a kind of a "B Team" if you will. And oh yes, being lesser lights, these companies had more reasonable valuations in August, 2000 than did our Dream Team.

Table 4 - B-Team Portfolio - Investor Total Returns

Five Years, 8/30/00 - 8/30/05, Including Dividends

$10,000 Invested in Each Stock at Start of Period

B-Team Company	Corresponding Dream Team Company	Value of $10K Investment at End of Period	Cumulative Percent Gained or Lost	Annualized Total Return (%/Year)
Cadbury Schweppes	(Coca-Cola)	19,220	92.2%	14.0%
Apple Computer	(Dell)	18,020	80.2%	12.5%
United Technologies	(General Electric)	17,660	76.6%	12.0%
Autodesk	(Microsoft)	59,450	494.5%	42.8%
JC Penney	(Wal-Mart)	33,450	234.5%	27.3%
B-TEAM PORTFOLIO		**147,800**	**195.6%**	**24.2%**

Table 4 shows the B Team roster, with each company alongside its Dream Team counterpart. In place of Coca Cola, we have Cadbury Schweppes, the British company that owns the Dr. Pepper, 7-Up and Snapple brands. Nice brands, but lacking the aura of the Coca Cola brand (what brand doesn't?). Matched up with Dell we have Apple Computer. Apple is a good company of course, but in 2000 many observers wondered if Apple even had much of a future. Apple has been rejuvenated since then, but it hasn't outperformed Dell even in relative measures. In 2000 it had 25% of Dell's sales and 27% as much profit, versus 24% of Dell's sales and 28% of its profits now. So its economic performance over the period was roughly the same as Dell's. And Dell's PC market share dwarf's Apple's even more now than it did in 2000 (lucky for Apple, Dell doesn't have an iPod!). Paired with General Electric, we have United Technologies. United Technologies is not a household name, but it had $26B in revenues in 2000, and will reach $42B this year. Like GE it is a highly diversified industrial company, but lacks GE's reputation for world class management, and is still only a quarter of GE's size. It operates in the aerospace and defense industries (e.g., Pratt & Whitney engines), building systems (Carrier HVAC systems) and various other industries (helicopters, elevators, security and fire protection systems, electronic controls, etc.). As a software company in place of Microsoft we have Autodesk. In contrast with Microsoft, Autodesk is a niche player, the world's leading design software company for architectural design. Despite its stellar reputation within its industry, if you were looking at Autodesk as an investment in 2000, you would have seen a troubled company. Its sales had decreased 14% from the year before, and its stock price was down 37% over the previous 5 years (a rare occurrence for an IT company in that era). Finally, in place of Wal-Mart we have J.C. Penney. Penney may not sound too exciting as a stock choice today, but its situation was far worse five years ago. In 2000 its net profits were only $78M, having fallen from $654M just two years earlier, and its $15 stock price on August 30, 2000 was down over 80% from its high two years earlier. As we know, Penney has made something of a comeback, but it is only in the past four quarters that its EPS has finally exceeded its value back in 1998.

B Team Stock Performance – So how did this B Team portfolio perform for investors compared to the Dream Team? In a word, splendidly. As you can see in Table 4, all five of these companies produced healthy investor returns over the past five years. The average annualized total return for the group was 24.2% per year. If you had invested $50,000, equally divided amongst these companies on 8/30/00, your invetment would have grown, inclusive of dividends, to $147,800 in five years, for a cumulative portfolio gain of 196%[8]. This compares quite nicely to a similar Dream Team's portfolio loss of $7,400 or minus 15%.

Is There a Time for the Dream Team? - Does this mean we should always avoid the very best companies as investments? Not at all. I'd still rather own the Dream Team portfolio for the long run, but only if I could buy it at good (i.e., cheap) prices. Really top quality companies tend to be widely known as such, so it is rare that you can find them at cheap prices. This is why you usually see value managers' portfolios populated by second and third tier companies. But if and when a top quality company presents itself at a bargain price, due for example to short term problems (like Anheuser Busch?) or general disenchantment with the industry (like pharmaceuticals today?), we should jump on it.

Table 5 - PE Ratios - Now Versus 5 and 10 Years Ago

PE for Trailing 12 Months

Company	**Trailing PE Start of Period 8/30/1995**	**Trailing PE Start of Period 8/30/2000**	**Trailing PE End of Period 8/30/2005**
Coca-Cola	26.8	83.5	22.1
Dell	11.6	58.7	27.9
General Electric	15.1	49.4	20.3
Microsoft	28.2	41.2	26.4
Wal-Mart	20.4	35.4	17.8
PORTFOLIO	**20.4**	**53.6**	**22.9**

For a great example of such a bargain time for blue chips, let's move the purchase date for our Dream Team stocks back five more years to August of 1995. Consider Table 5 which adds to Table 3 by including the Dream Team stocks' PE ratios in 1995 as well as in 2000 and 2005. We see that the portfolio's PE averaged only 20.4 in 1995, which is less than half the value in 2000, and is even lower than the current value of 22.9. If we bought the stocks at those prices

[8] Even if we left out the best of the five B Team companies, Autodesk, which returned 42.8% per year, the other four companies still enjoyed an average annualized return of 19.7%, and a cumulative five year gain on investment of 146%.

ten years ago, we would have received the benefits of all their glorious growth of earnings over the decade, without having to suffer any dilution of returns due to PE declines. Of course, there is more than a little bit of hindsight analysis going on here, but the purpose is just to illustrate the point that buying at reasonable if not downright cheap prices is always a good way to increase your probability of success.

To see how the Dream Team portfolio performed over the whole ten year period, see Table 6. This is more like what one would hope for with such an august list of companies. Each stock except Coca Cola had an annualized gain of at least 14% per year over the ten years[9]. The portfolio as a whole would have turned an initial $50,000, equally invested in each stock, into $444,000 in ten years, for a cumulative gain of 788% and an average annualized total return of 24.4%[10].

Table 6 - Dream Team Ten Year Investor Total Returns

Five Years, 8/30/95 - 8/30/05, Including Dividends

$10,000 Invested in Each Stock at Start of Period

Company	Value of $10K Investment at End of Period	Cumulative Percent Gained or Lost	Annualized Total Return (%/Year)
Coca-Cola	15,680	57%	4.6%
Dell	297,480	2875%	40.4%
General Electric	39,650	297%	14.8%
Microsoft	52,860	429%	18.1%
Wal-Mart	38,390	284%	14.4%
PORTFOLIO	**444,060**	**788%**	**24.4%**

I have emphasized the idea that in stock investing, the price always matters. But is that all that matters? No, an attractive discount to one's assessment of fair value is a ***necessary condition*** for buying a stock, but other factors do matter too. Two that are worth mentioning are economic moats and company management.

Economic Moats - The term "economic moat" was originally coined by the famous investor and Berkshire Hathaway chairman, Warren Buffet, and the concept is in fairly widespread use now, including at Morningstar. An economic moat is defined as a long term, sustainable competitive advantage. A moat can arise from several sources, such as a top brand names (Coca Cola), patents (Pfizer), scale economies (Intel), high customer switching costs (Moodys), and/or network effects (eBay). A low stock price itself is usually not enough for a successful *long term* investment. The company must still perform economically, first of all well enough to earn the market price we think it currently deserves, and secondly to continue

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[9] Notice that Coke's PE ratio was still pretty high in 1995, at 26.8, and was the highest relative to current PE's of any of the stocks. Still, it did earn a positive return of 4.6% per year, or 57% cumulatively over the period. Furthermore, its return for the period 1995 to 2000 averaged 12.2% per year.

[10] Dell was by far the best performer of the bunch over the ten year horizon, and accounted for almost three quarters of the portfolio's gain. But even leaving it out, the portfolio would have gained 96% and had an annualized return of 13.9% per year over that period.

generating the earnings growth necessary for the stock to keep increasing in value and/or paying dividends. Other than the blind luck of being in the right place at the right time, having a long term, sustainable competitive advantage – an economic moat – is what a company needs to do this.

Think about how you make money out of a stock investment. The two sources of return are capital gains and dividends. And, in turn, since a stock's price is equal to it earnings per share times its PE ratio, the two sources of capital gains are increases in earnings per share and increases in PE ratio. While an increase in the PE ratio can give a nice kick to a stock price, it is not generally a long term continuing process. To continue generating capital gains over a long haul, a company must be able to keep on increasing its EPS as well; i.e., it has to have not just steady earnings, but earnings growth. And this is where the idea of an economic moat comes in. It is, essentially by definition, what a company needs to give us confidence that it can sustain good earnings growth over the long term.

Warren Buffet also had a name for substantially undervalued stocks of companies with no economic moats and/or poor future prospects. He called such "cigar butt" stocks. If you find them you can pick them up and get a "few good puffs out of them", but they are not the kind you are going to be holding over the long term. There is nothing wrong with making money out of cigar butt stocks, and sometimes these may be the only under-valued companies you can find. But if you want to buy stocks with the idea of holding them for several years rather than several months, then wide moat stocks are the preferred way to go. A cigar butt stock is likely to benefit only from an increase in its PE ratio, and this is not likely to be a long term, continuing process. Once its PE ratio reverts to a fair value (if it ever does), you are finished.

In conclusion, we'd most like to own stocks with *both* low valuations and wide moats. Our discussion of the Dream Team portfolio's performance dramatizes the importance of insisting on low valuations no matter how good the company or how wide its moat, while Warren Buffet's "cigar butt" analogy helps explain why cheapness alone should not be the only objective either. There is no quantitative way of assigning or measuring an economic moat, but it is possible to develop a qualitative opinion on the degree of moat a company may possess, and this is an important part of assessing a stock investment.

Company Management - Another factor aside from price valuation and economic moats that is important to consider in buying stocks is the attractiveness of the company's management, both in terms of its basic competence and in terms of its "stewardship". Stewardship is the degree to which a company's management and its management structures are aligned with shareholder interests. It has to do with disclosure, ethics, management compensation and incentives, and overall shareholder friendliness. These are clearly subjective matters, but Morningstar, for one, now actually assigns stewardship grades to the companies it covers, based on their analysts' assessments of twenty specific items having to do with shareholder interests. While these are not easy matters for an outsider to evaluate, in the era of the Enron, WorldCom and Tyco disasters, it should go without saying that it is essential to make the effort. We will never be sure a company has bad management, but if it appears suspect, we should not buy its stock no matter how attractive its stock price and growth prospects may be. There are thousands of stocks to choose from, and there is no penalty for taking as many pitches as we like.

Summary and Conclusion – In summary, I have stressed that having a good price should be a necessary condition for buying any stock. Don't buy the stock of even a "dream team" kind of company if the price is not right. Faced with the choice of owning a great company at an inflated price, or a not-so-great (but not bad!) company at a bargain price, we should opt for the bargain any day. Nevertheless, our most preferred kind of stock to own would be a top quality company with a wide economic moat and competent, shareholder-oriented management.

If we have the patience, there are fleeting times when Mr. Market will offer such companies to us at bargain prices. In fact, now may be such a time. There has been a continuing market disenchantment with large cap growth stocks since the bursting of the TMT[11] bubble, most of it richly deserved. But the disenchantment seems to have been pretty indiscriminate and in some cases has gone too far. As a result, some of the highest quality companies like our Dream Team members and others such as Pfizer, Anheuser Busch and Home Depot, are now making rare appearances on value manager lists as possible buy candidates. And in fact, these kinds of companies are increasingly being included in our own portfolios, both in the individual stocks I buy and in the portfolios of the mutual fund managers we have selected.

[11] "TMT" stands for "technology, media and telecommunications".