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INTERVIEW

Home on the Range

Vitaliy N. Katsenelson, Director of Research/Portfolio Manager, Investment Management Associates

By LAWRENCE C. STRAUSS

AN INTERVIEW WITH VITALIY N. KATSENELSON: This money manager explains how to invest in a range-bound market that could last 10 years.

VITALIY N. KATSENELSON SPENT HIS YOUTH in Murmansk, a city in northwest Russia perhaps best known to Westerners as a setting for *The Hunt for Red October*.

The Russian navy was a popular career track there. But Katsenelson, now 36, emigrated to the U.S. with his family in 1991, when he was 18. He took a keen interest in finance, earning undergraduate and graduate degrees at the University of Colorado/Denver. Since 1997, he has worked at Investment Management Associates, a Denver money manager with assets of about \$60 million.



Don Cudney for Barron's

"Buy-and-hold became a religion...but when stocks become fairly valued, you sell them." --Vitaliy N. Katsenelson

Katsenelson employs his active-value, or "buy-and-sell," style in overseeing equity portfolios there: He'll happily put money in cash when there aren't enough compelling stocks around. Today, he maintains, the market is range-bound, meaning price/earnings ratios are under attack.

In 2007, Katsenelson published *Active Value Investing*, a book that outlines his framework for portfolio management and stock-picking. From Dec. 31, 2005, through June 30 of this year, his value strategy has earned an average annual total return of 0.64%, versus a 6.39% decline for the Standard & Poor's 500. *Barron's* spoke with him last week by phone.

Barron's: *Your book stresses the importance of understanding range-bound markets. Why is this critical for investors?*

Katsenelson: Over the last 100 years, every time we had a secular bull market it lasted 16, 17 years. But the markets that followed were not bear markets; they were range-bound markets. The only exception was the Great Depression. It is a very important distinction, because you should invest differently in a bear market than you would in a range-bound market. In any range-bound market, you have high starting valuations, which are a byproduct of the secular bull market. If earnings growth becomes negative and stays negative for a long time, you have a bear market. A great example of that is Japan, which has had high valuations and contracting earnings for a long time.

Would an example of a range-bound market be what occurred in the U.S. from 1966 to 1982?

Yes, that's right. The current range-bound market started in the early 2000s. There are two forces working against each other: growing earnings and contracting P/E multiples. The whole idea behind a range-bound market is that P/Es need to get deflated over time.

Range-bound markets are not caused by horrible earnings growth; in fact, earnings growth during range-bound markets is not much different from bull markets. A lot of times people refer to the average P/E as being 15 times earnings, which is true, but markets spend very little time at the average. The average P/E historically has run from above average to below average. It never stopped at the average. It goes from one extreme to the other.

Do you look at the market's rally since March of this year in the context of a range-bound market?

I do. A range-bound market basically goes nowhere for a long time, although it has a lot of cyclical volatility. During the 1966-to-1982 range-bound market, there were five little bull markets and five little bear markets. So the question is, "Where is it today?"

You really need to figure out what the earnings power of the S&P 500 is, but that gets a little tricky. If you look at the 2010 operating-earnings estimate for the S&P 500, it's about \$73 a share. But reported-earnings estimates are \$46 a share, so there is a big difference.

Why the big discrepancy?

Writeoffs. The true earnings power of the S&P 500 is probably somewhere in the middle. I'm very suspicious of the \$73-a-share estimate -- because in 2007, when we had a perfect storm of three or four different bubbles colliding and profit margins at all-time highs, earnings were about \$85 a share. I just don't see how, after all that has happened, you could get to \$12 below the all-time high for earnings three years later. If you say next year's earnings of the S&P 500 are \$50 to \$60 a share, the index is trading at 18 to 21 times.

Which is not that cheap.

No, it's not. We are in the middle of a range-bound market that could last 10 years.

Give us an example of how this type of market impacts an individual stock.

[Wal-Mart](#) [ticker: WMT] is a perfect example. In 2000 it was trading at 45 times earnings, and it earned \$1.25 a share. Fast-forward to today, and its earnings have more or less tripled. They grew about 12% a year. At the same time, its P/E contracted from 45 times to about 14 times.

Wal-Mart's stock is back at the same level it was in 2000, despite earnings having almost tripled, because its P/E contracted at a very similar rate. In today's environment, investors should favor absolute-valuation tools, like discounted-cash-flow analysis or breakup analysis, as opposed to relative-valuation analysis -- i.e., Wal-Mart is cheap at a P/E of 14, because it used to trade at 45. Relative valuation is a backward-looking tool, and anchors on valuations that we'll not see again for a long time. That will lead investors into a relative-valuation trap, and lead to overpaying for stocks.

Talk about how margins helped stocks appreciate, and how that has changed.

When profit margins were at all-time highs in 2007, they were for the most part driven by incredibly high margins in two types of stocks -- the financials and what I call the "stuff" stocks. Those include the industrial stocks, the commodities and energy.

Interestingly, the earnings for those companies were still expanding, even though the U.S. economy was already in a recession. And although our economy was slowing down, the global economy, especially China, was driving the bulk of the growth.

The "stuff" stocks, especially, have some common characteristics. They are consumer-cyclical, they have very high operating leverage, and, for the most part, they are considered lower-quality stocks, partly because they are very cyclical and have high

operating leverage. The operating leverage works both ways. When the global economy is expanding and earnings are growing, their costs grow more slowly than their revenue. Therefore, margins compound dramatically.

But the problem is that operating leverage works in the other direction, too. When the sales collapse, they can't cut their costs fast enough. This is extremely important for a couple of reasons. No. 1, unless you think the global economy will be growing at the rate it grew in the past, the demand for the goods those companies produce will be lower going forward. No. 2, whatever earnings those companies had in 2007, they are not going to see them again for a long time. If you apply it to the macro level, the earnings for the S&P 500 are not going to get to \$85 a share for a long time.

Katsenelson's Picks		
Company	Ticker	Recent Price
Vodafone	VOD	\$23.24
CareFusion	CFN	21.43

Source: Bloomberg

Why do you think that being in stocks is not superior to being in bonds or cash?

In 1982, if you took a monkey and gave it some darts to throw at a *Barron's* stock table to create a portfolio, it is likely that portfolio would do better than fixed-income instruments over the span of the secular bull market. That's because the performance of stocks versus bonds and Treasury bills is so much greater during a secular bull market, as was the case from 1982 to 2000. During range-bound markets, the broad market does not necessarily do that much better than T-bills or bonds. So being in stocks is not as important as being in the right stocks. The stock selection matters significantly. And the opportunity cost of being in cash is a lot lower. But I don't think most mutual funds are naturally equipped to invest in today's environment.

Why not?

Because of their mandates to be fully invested all the time. So in an environment where you have to be extremely selective in what you own, it is important not just what you own, but what you don't own. And if you have to be fully invested all the time, you end up owning marginal stocks.

Why do you think the buy-and-hold strategy doesn't work in this kind of a market?

First of all, you can mathematically explain the change in stock prices for two reasons: Either earnings are growing, or P/E multiples are expanding or contracting. During secular bull markets, you buy stocks and their P/Es are expanding, and they usually expand to an above-the-average P/E. That teaches investors to buy but never sell stocks, because when [stocks] approached their fair value and investors sold them, they lost a lot of money. That's because P/Es go to above-average levels in a secular bull market, driven by investor psychology.

What happens in range-bound markets?

As P/Es compress, they go from being your friend to your enemy. Therefore, if you just buy stocks and hold them, unless you found the next Microsoft that can grow earnings 30% a year for the next 40 years and offset any P/E compression, you want to be a buy-and-sell investor. Buy and hold became a religion; it almost became buy and forget to sell. Instead, you have to buy stocks when they are undervalued. When they become fairly valued, you sell them, and you put the proceeds in cash, and you look for other stocks that meet your criteria.

Is the average retail investor equipped to do that?

Retail investors can do that, but they need to modify their investment process.

But with a buy-and-sell strategy, aren't your transaction costs much higher?

I'm not talking about day-trading. Say I bought a stock and I was looking for a 50% return and it appreciated to its fair value -- which I define as what I think a company is worth. It may happen in a year, it may happen in five days, though it's never happened to me in five days.

So instead of holding on to the stock hoping for something to happen when it's becoming overvalued, I say don't hope for that. You should sell it when you think it's fairly valued. Your transaction costs will go up, but so should your returns. I do hold stocks for years, in many cases, but I'm against just holding for the sake of holding.

If you look at the market and can't find enough stocks that meet your criteria, then you are going to have more cash. You are not timing the market, which is extremely difficult to do consistently.

You devote some of your book to the importance of finding a margin of safety in a stock. Could you elaborate?

You want to increase your margin of safety because, especially in this environment, you are facing two enemies: P/E compression and trying to figure out what the earnings power of a company is. A lot of the earnings we saw in 2006 and 2007 were inflated by macro events, such as excess liquidity. So you want to make sure if you buy a stock and you overestimate what the earnings power is, you won't get hurt very much. And you should favor stocks that pay higher dividends because the bulk of returns during range-bound markets comes from dividend-paying stocks. And you should start looking at markets outside the U.S.

In figuring out a margin of safety for a stock, are you looking at how far the price could drop?

That's right. You want the margin of safety to become a part of the return. If I think a company is worth \$100 and I can buy it at \$50, whatever kind of normalization there is towards fair value becomes a good source of the return. But if things don't go as well, the stock is cheap enough that it's not going to hurt me. That's why margin of safety is really important.

Another point you make in your book is the importance of finding hidden risk in a company, admittedly not an easy task. How do you go about doing that?

When you look at performance of a company or a manager, for that matter, you only see one reality. You only see one chain of events. You don't really know how much risk was taken to achieve the return.

Lehman Brothers was a great stock until it became a horrible stock. If a money manager owned Lehman for a long period of time, he made money. But the manager was taking a lot of risk, because Lehman used a lot of leverage. So when you look at a company, look at past performance and ask yourself, "If the environment was slightly different, what would have been the outcome?" In other words, don't just focus on the result. You want to look at how the result was achieved.

Let's move on and talk about a couple of stocks you find interesting.

[Vodafone](#) [VOD] is one of the largest global telecom companies. It's big in Europe, and it's fairly large in emerging markets. What attracted me to the stock is that it owns 45% of Verizon Wireless, which is a part of [Verizon Communications](#) [VZ].

What's interesting is that Verizon Wireless generally has a lot of free cash flow, but it hasn't distributed that free cash flow to Vodafone for a couple of years. The reason for that is that, in the past, Verizon Wireless was growing at a very fast rate, and upgrading its network. Last year it bought Alltel, and incurred \$20 billion of additional debt. The company has decided to pay off about \$10 billion of debt a year. Therefore, Vodafone was not receiving any cash flows from Verizon Wireless.

At the same time, we estimate the Verizon Wireless stake is worth around \$50 billion to \$55 billion. If you take the value of Verizon Wireless out of Vodafone, you are basically buying the other cash-generating businesses at about seven times free cash flow. That is incredibly cheap. You also have that 6%-plus dividend yield, and when the global economy starts to recover and emerging markets start to grow again, Vodafone's cash flows will start growing again as well.

Vodafone's stock has bounced around in the past year, although it's flat year to year. What caused that?

In the last year, a lot of its business has come from Central Europe and emerging markets. In those markets, people consume telecom services differently. Instead of having a fixed, monthly phone-payment plan like we have in United States or Europe, they buy minutes in bulk, buying a couple of hundred minutes at a time.

When the global economy starts to contract, the demand for minutes declines dramatically -- I think it is down 6%, 7% in emerging markets. Those markets were a lot more cyclical. However, when the global economy starts to recover, the demand for telecom service in emerging markets goes up again, and Vodafone's cash flows will rebound.

What else looks interesting?

Carefusion [CFN] is a provider of medical technology and services to hospitals. It was recently spun off from [Cardinal Health](#) [CAH], a drug distributor. It was not a good fit with its former parent. It accounted for about 4% of Cardinal Health's revenues and more than 30% of its operating income. Carefusion is a classic spin-off: It was undermanaged and underinvested. Cardinal's distribution business operates with razor-thin margins. It focuses on being very efficient. Carefusion is basically a technology company. So it's a very different business.

In the right hands -- and properly incentivized and managed, which it is -- this company could have much higher margins. Cardinal retained a 20% share in the company, so it has an incentive for Carefusion to succeed. As a result, it did not saddle the company with a huge amount of debt. It's currently about \$1.4 billion, versus \$640 million of cash. It operates in a difficult space, because hospitals are under pressure in this economic downturn. But at the same, its products help to make hospitals more efficient. Also, since Carefusion leases its machines to hospitals, a nice component of revenues is recurring. Competitors' net margins range from 12% to 18%, so Carefusion could get to the middle of that range.

You have been skeptical about China's growth, and about investing in China. Are you still?

Yes. In the past six months, to achieve growth at any cost, the Chinese government injected an incredible amount of money into the economy, and made existing problems worse. The Chinese economy was geared for much higher growth in the rest of the world, but global economic growth will be lower going forward. Meanwhile, China has very high operational and financial leverage.

Thanks, Vitaliy.

E-mail comments to editors@barrons.com

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