Beyond the Sound Bite
…an in-depth interview with:

Mr. David Dreman
Chairman
Dreman Value Management

Category: Markets

Vinny's Comments: The renowned value investor believes that there are more values today than at any time since 1990. He also believes that there appears to be a large amount of indiscriminate selling. Such selling is producing many attractive values. He cautions, however, that there are still issues and sectors that remain overvalued, in his estimation. Yet, even within these groups, one can find attractive issues.

MR. VINCENT CATALANO: Hello, this is Vincent Catalano, and welcome to Beyond the Sound Bite. Today I have the pleasure of speaking with David Dreman. David is Chairman of Dreman Value Management. He is also the Founder and Chairman of the Institute of Psychology and Markets. David, welcome.

MR. DAVID DREMAN: Thank you, Vincent.

Market Overview

MR. CATALANO: David, I'd like to get your sense of where you see the markets now, and then get to some specifics in terms of sectors and issues that you like and don't like. So, please give us, if you would, your overview on where things are in the markets today?

MR. DREMAN: Unfortunately, I don't see an end to this enormous volatility that we've had for some time, and….

MR. CATALANO: The volatility as in downside volatility?

MR. DREMAN: Yeah, the downside volatility, yes. There is just nothing there that makes me think it's going to change very quickly. I think the overhang of the possibility of military action with Iraq is really a negative for the market because it hits the market at a time where the people are very pessimistic in any case, and it probably magnifies the fears, you know, out of proportion. So I think that we will continue to see this… unfortunately, this kind of market for at least several months to come, maybe longer, but I also think there is some enormous values out there, and anybody who does have the ability to go in (and possibly not read the stock pages everyday) should do well looking out two to three years; it might do exceptionally well.

MR. CATALANO: Are you seeing more of that today than you did, let's say six months ago, a year ago?

MR. DREMAN: Oh, absolutely. I think I've seen more values out there than I've seen since 1990. It really… there have been very few periods in history where you can get some pretty strong companies yielding 7 to 8 percent, and even a few over 10 percent. Really, that's what we're seeing now, but, again, to sort of balance it, unfortunately, it seems that I think the last time we talked, we talked about earnings estimates being pretty high, and that hasn't changed. It's amazing that, after the bubble, for example, in technology, the tech analysts are still very, very high on their estimates, particularly in the NASDAQ 100. I think they're looking for something like a 70 percent gain in the fourth quarter in NASDAQ earnings and then something like a 40 percent gain next year. There's just no indication, Vincent, at this point in time that there is any kind of an upturn in IT.

MR. CATALANO: So the values that you see are not in all sectors; they are in certain sectors and certainly they are not in the technology sector as a rule.

MR. DREMAN: Yes, and even the overall S&P is still reasonably high. It's something like 20 times pro forma earnings for this year, and the estimates are I think stretched a little for the fourth quarter. We've seen how much they've already come down for the third quarter and going into next year, on an operating earnings basis may be 15, 16, but I think, again, those estimates are a little bit high, so there's still a chance for earnings disappointment for the overall market, which is not a good thing, obviously.

MR. CATALANO: You are more of a longer-term investor, correct?

MR. DREMAN: Correct.

Asset Allocation Decisions

MR. CATALANO: Do you go about making asset allocation decisions first? I know that you take an economic top-down and you look around for values. Do you make that asset allocation decision?

MR. DREMAN: Yes, we do. I think one of the things we've found over time is it's a good thing not to change them. Looking at institutional investing over a fairly long period of time, institutions tend to go into fixed income right near the bottom of the market then tend to (increase their) equity exposure near the tops, and the smart thing is to really, once you've decided on (your) equity, fixed income asset mix, you have is to just stick with it through all kinds of markets.

MR. CATALANO: Okay, and so a longer-term investor might have a 70/30 mix, just for argument's sake. What you would advise that person, within that 70 percent area, to go with what the better values are, or where the better values are?

MR. DREMAN: Yes, and I think there's still a dichotomy in this market in the sense that a lot of the value stocks are getting hit badly, too, in a panicky market (such as the one we're experiencing now), there isn't a lot of differentiation. People don't look at fundamentals, just like they didn't look at fundamentals at the top of the bubble, so a cheap company that has earnings slow down a little bit, or a value company that has earnings down slightly will get hit just as hard, and so we're getting a lot of good value companies trading at, oh, 10, 12 times earnings. Sometimes as low as 6 and 7 times earnings (and have) grown anywhere from 10 to 15 percent a year.

MR. CATALANO: So the behavior appears to be beginning to be fairly indiscriminate?

MR. DREMAN: Yeah, very definitely. In the last quarter, for example, looking at the major mutual funds, the value funds got hit a little bit worse than the growth funds, and I think that's just a sign of a very unsettled, panicky market.

Other Concerns and Issues

MR. CATALANO: Let's look at the (concerns over) Iraq. Let's also look at some of the other concerns that the market might be preoccupied with. One of them is a category called "Crisis of Confidence." We've done a lot of work in that area, we've run an event. It produced material in that regard; the crisis of corporate accountability and Wall Street research and such. How much of that do you think is a factor (in the market) today?

MR. DREMAN: I think it's a big factor, and you can just see that every kind of company has to restate earnings or there's an SEC inquiry on the company. These stocks just plummet and it's something that we're probably going to take awhile to get through. Certainly there have been a lot of improvements made, but the… I think the whole question of accounting GAAP, accounting versus operating earnings, which can be anything a company wants them to be, hasn't really been addressed and the SEC was going to appoint somebody very strong for the Financial Accounting Standards Board and now they've kind of waffled on that temporarily. I think that investors have to have more confidence that the numbers they see are very… are real numbers and are comparable with other firms, and I don't think we've reached that point yet.

MR. CATALANO: And are there other concerns that you think the market is preoccupied with? Are investors preoccupied with (this Crisis of Confidence which is) creating this atmosphere of indiscriminate behavior?

MR. DREMAN: Yes. Well, actually, after a bubble (the 1997 to early 2000 bubble) which is probably the worst in not only American history, but the worst in recent world history, it takes a long time to recover. I mean, there's something like $8 trillion that has been lost from the top, and that really creates jitters and it makes people I guess cautious for quite some time.

MR. CATALANO: And it affects their behavior going forward for quite a period of time.

MR. DREMAN: Oh, I think so.

MR. CATALANO: Like the aftereffects and the aftershocks?

MR. DREMAN: Yes.

Sectors and Stocks

MR. CATALANO: Let's go from the larger picture and the asset mix and all, down to some particular sectors and areas that you like. Earlier this year you liked the financials and pharmaceuticals. You suggested, correctly, to stay away from cyclicals. What sectors are you looking at now? What do you like, and what don't you like?

MR. DREMAN: I guess we still like the financials, and I still very much like Freddie Mac and Fannie Mae, although they're considerably cheaper as are most financials now, but these are two companies that are growing at 15 percent a year, they've had a lot of negative media exposure and the bulk of it, simply, is not very problematic, although the companies really are run pretty cleanly. They're at 10 times earnings and their growth is like 15 percent this year and very close to that next year, and again, they're trading at half the P/E of the S&P, and are much solider companies. Another group are the tobaccos. Now, they lost a couple of major cases recently, particularly that one in California a week or so ago where there was a $31 billion or $32 billion award. Well, the normal awards are something like four times the award for lost services or lost earnings, and this one was 33,000 times that amount. So, it's very likely that the $31 billion will be cut to something closer to, oh, $70 million or $80 million, and that will be appealed for years to come and, yet… these kinds of awards don't hurt these tobacco companies much, and yet the companies in panicky market just have been knocked down very sharply yielding almost 7 percent right now and having paid and increased its dividend I think every year but one in the last 55 years.

MR. CATALANO: What about healthcare? Any views on healthcare? You had mentioned like pharmaceuticals before. Healthcare is obviously a large, diverse group. What's your view there?

MR. DREMAN: I like healthcare. Some of the company… the pharmaceuticals have really been hit, and probably a little bit too much, but again, there's headline exposure and that's probably knocked the stocks below where they should be, and we still like Merck. It has some new products that will be online, possibly blockbusters in a couple of years, and they're trading it at lower-than-market (multiple). They have excellent finances and should grow faster than the S&P over time (probably 10 percent, 12 percent growth). Bristol-Myers is another company that has really been battered down. The company's obviously made from the straights, but it's still got a very good base for earnings growth and a number of interesting products coming on line. All of them have above-average dividends and, financially, they are very, very strong.

MR. CATALANO: And, obviously, I think in this era of full disclosure, the issues that you've mentioned are ones when you say you like them, but that also means that you own them?

MR. DREMAN: Yes. I think I own all of the companies I've recommended so far.

MR. CATALANO: Well, what sectors do you not like? You had said months ago about cyclical (stocks)?

MR. DREMAN: Yes, and I guess I think that the technology stocks on the whole, even though some of them are down, you know, 80, 90 percent or more are still problematical, and so I wouldn't step into an Oracle or Dell quickly. I think that the earnings growth just won't be there for some time, and when the market does turn around, I think these stocks will probably lag, so there will be some major opportunities, but I think we have a little time to wait.

MR. CATALANO: Do you like any of the communications companies? Some of the Baby Bells?

MR. DREMAN: Yeah, we've looked at them and we don't see a lot of growth for some time. One company, though, that is starting to be more interesting to us is (in technology) is EDS. Since the stock had a high of 70 and, more recently, was (I guess about two, three weeks ago) was 40 and now it's been down to 10 and it's 12 now. The management came out with a release that shocked the sheet about lower earnings this year, but, even so, they'll earn $2 a share this year, probably $2 next year in a bad economic environment, and probably has significant growth ahead of it. There are cash flow concerns, but I think they're overstated, and I think that that's the kind of stock that might do well over time.

Behavioral Finance

MR. CATALANO: Very good. I'd like to change the subject to behavioral finance. You are the Founder and Chair of the Institute of Psychology and Markets, and just in the past couple of days, the Nobel Prize for economics was awarded to one of your board members, Vernon Smith.

MR. DREMAN: Yes.

MR. CATALANO: Daniel Kahneman also won an award. There was a co-share, I believe, this year. So, that's obviously a terrific boost to an area that you have been very actively involved with for some time now.

MR. DREMAN: Yes. Behavioral finance really explains a lot of the rationality that we see in markets. It explains why stocks to get priced to the bubble levels, and it also explains the other side of the overreaction; when stocks come down, they come down very sharply, and what these people have found and other researchers have found is they are pretty consistent patterns of behavior and they are easily identified viable, and those who can actually stick to these disciplines that come out of them, like a contrarian investment strategy, which is really derived directly from behavioral finance, can do very well over time, but again, you really have to understand them, because it's hard to stick by the strategies even though the statistics are overwhelmingly in favor of them.

MR. CATALANO: I love that price-to-bubble ratio. That's very good. I think you've developed a new metric. I do encourage everyone who is listening and/or reading the transcript of this interview to take a look at PsychologyandMarkets.org. There's an event coming up in November (November 7th) here in New York and David is going to be a speaker and Psychology and Markets has put it together; the Institute has put it together, so it should be a very, very good event, and we hope that you look into this event further.

For the past number of moments, I've had the pleasure of speaking with David Dreman, Chairman of Dreman Value Management and Founder and Chair of the Institute of Psychology and Markets. He has covered quite a bit of ground for us and we very much appreciate your time today, David. Thank you.

MR. DREMAN: Thank you for having me, Vincent.