

Sticking to a time-tested investment strategy has proven to be the most effective means of generating excess returns over the long haul. Patience may be one of the most powerful tools available today.

### Trying Times

The past nine months in the financial markets have strained the patience of even the most seasoned investor. Uncertainties surrounding the length and depth of the recession and the impact of government fiscal and monetary actions have led some investors to move to the sidelines, waiting for a clear signal as to when the bottom is behind us and it's safe to get back into the market. While it is highly tempting to try and time the market or to try and integrate economic forecasts into thinking about the markets, the record on doing so is highly suspect. For example, in the last 16 trading days of the quarter (from the market's bottom), the S&P 500 was up over 16%, despite being in the midst of mostly unsettling economic data.

The record on this topic is quite clear. Morningstar calculates "investor returns" as distinct from "fund returns" to reflect the timing decisions that actual mutual fund investors make. A study by Dalbar, Inc. covering a 20 year period through December 31, 2007 confirmed that the results of investors' timing decisions are dismal, with the average equity mutual fund investor achieving a 4.48% annualized return, underperforming the S&P 500 by over 7% per annum. Institutional investors suffered a similar fate. A study by Amit Goyal of Emory University and Sunil Wahal of Arizona State University found that for the three years after a firing decision is made, the corresponding excess return generated by the fired manager is a positive 4.3%.

Absent an unusual talent for market timing, sticking to a

time-tested investment strategy has proven to be the most effective means of generating excess returns over the long haul, even despite the inevitable setbacks that are part of such a strategy. Let's examine the record for value investing.

### Deep Value Investing Works

We've all seen the Fama/French data that shows that over long periods of time, investing in companies with low price-to-book value generates significant excess returns. Our own version of the calculation is shown below:

	Annualized Return 1/1/79 - 3/31/09
Cheapest Quintile <sup>(1)</sup>	13.5%
Russell 1000® Value Index	11.1%
S&P 500 Index	10.6%

(1) Cheapest quintile of largest 1000 U.S. listed stocks

But what investors often miss is that value indices, such as the Russell 1000® Value, don't really capture the essence of value investing studied by Fama and French. In Figure 1 we present the cumulative returns of a naive low price-to-book strategy relative to the Russell 1000® Value over the last thirty years.

Two significant observations are readily apparent:

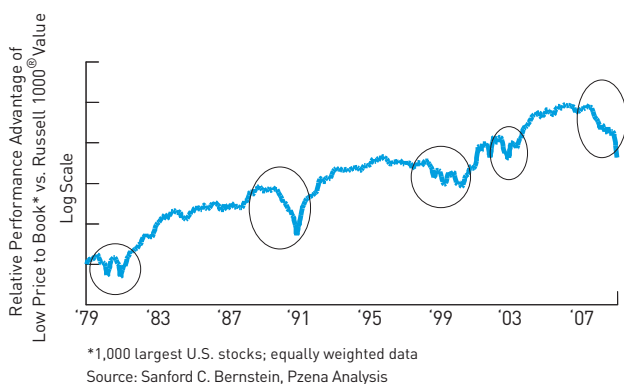
1. Low price-to-book clearly outperforms the Russell 1000® Value over time providing an average of 242 basis points of excess return per annum over the 30 year period, and
2. The generally upward slope of the graph is punctuated by five periods of significant underperformance (defined as declines of 10% or more in the cumulative level of out-performance), yet the long-term track record remains intact despite these periods of volatility.

In sum, for the investor that was willing to endure the periods of underperformance which were at times extreme, the payoff has been quite large over the entire market cycle. Our own performance has mimicked that of the deep value proxy. Our Pzena Value strategy underperformed by 19.8% from January 2006 through November 2008 (though by not quite as much as the 21.1% that low price-to-book underperformed) yet we have added significant value over the Russell 1000® Value over the long-term. Even after two powerful anti-value cycles, Pzena Value has generated 48.0% of cumulative outperformance since our inception.

### How the Cycles Played Out

Each value cycle has its own unique characteristics, but there are many similarities. We will attempt to analyze the two most recent anti-value cycles to see what lessons we can learn -- the

**Figure 1: Deep Value Adds Excess Return in Spite of Volatility**  
Low Price-to-Book Maintains a 200 Basis Point Annual Performance Premium Despite Five Periods of Underperformance Relative to Russell 1000® Value Index



“dot.com” heyday and its recessionary aftermath and the commodity run-up/financial crisis / recession of ‘06 – ‘08.

As we have written about in our recent newsletters, the pre-recession, anti-value cycles are characterized by investor sentiment and momentum that trump issues of valuation. Investors scurry to exit from those sectors that they fear will be negatively impacted by the cycle regardless of valuation, and at the same time they “ride the winners” that they perceive will not be impacted by the economic cycle. Pure value investors like us, tend to underperform during these periods since we have little or no exposure to “hot” momentum areas and sometimes are caught in positions that fail.

During the “dot.com” period, we missed out on performance from tech, telecom and media, and also had a few failures in our portfolio, the most notable of which was Fruit of the Loom. In the case of Fruit of the Loom, our analysis of the franchise value turned out to be accurate, but the company was restructured and we, as shareholders, didn’t get to participate in that franchise value (Warren Buffet did as he bought it out of bankruptcy). During the most recent anti-value cycle, we did not have exposure to the hot momentum sectors, energy and commodities. Similarly, we experienced a number of failures among our financial holdings, most notably Fannie Mae and Freddie Mac. Fannie and Freddie were taken into government conservatorship and will wind up being restructured (we believe) into viable business enterprises in the future. But, it is irrelevant since we won’t get to participate in its future franchise value.

The obvious questions are how do we avoid such failures and can we outperform during the long-term even if we happen to get caught with them. As you might imagine, we spend countless hours trying to modify our process to avoid repeating mistakes in the future. But the compelling conclusion is that even with the failures, we have managed to generate an impres-

sive long-term record.

During the “dot.com” period, we underperformed the Russell 1000® Value by 33.0 percentage points from peak to trough. The major sources of underperformance were the lack of exposure to technology and utilities (8.9% and 4.1%, respectively), as well as our over-exposure to materials and processing (4.6%). But 12.9% of the underperformance came from the failure of Fruit of the Loom and Burlington Industries – two companies where we didn’t get a chance to recover our investment because they went bankrupt.

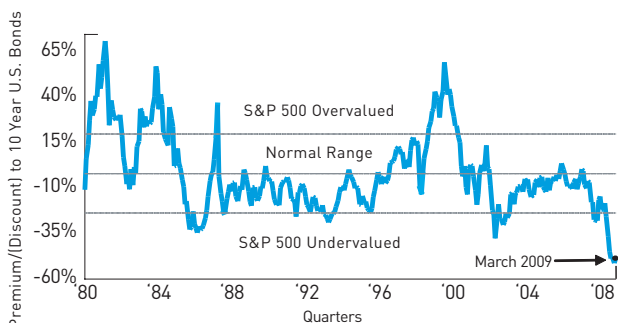
This cycle our total underperformance has been 19.8 percentage points peak to trough with 5.5% coming from underexposure to energy and 9.7% coming from the permanent failure of a number of our financial holdings. Can we recover the 9.7% points and still outperform in the long run?

Well, if the last cycle is any indication, we should. And the source of the outperformance during the last cycle was the avoidance of sectors that were overheated combined with exposure to companies and industries where valuations were extreme and fundamentals intact. In the period subsequent to the “dot.com” bust we not only made up the permanent impairments of 12.9%, but we outperformed in aggregate by 125.0%.

### Reasons for Hope

There are tangible reasons to believe that the excess returns of the past are available once again to the value investor. In fact, valuation data suggests that this may be one of the most opportune moments in a generation to construct a portfolio of deeply discounted businesses, many of which are leaders in their respective industries. We believe equity valuations in general are more undervalued than at any time in the past 30 years (Figure 2) and the most undervalued segment is at one of the most attractive relative valuation levels in almost 40 years (Figure 3).

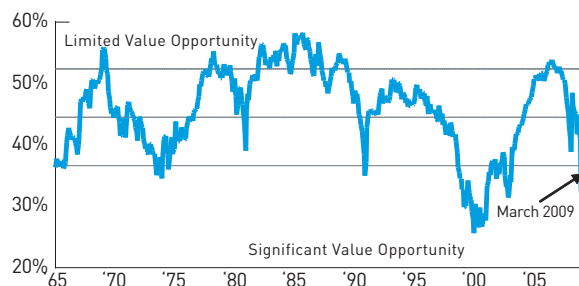
**Figure 2: S&P 500 Valuation Relative to Bond Market**  
Assuming Normal Equity Risk Premium



Source: Sanford C. Bernstein, Pzena Analysis

**Figure 3: The Value Opportunity**

Price/Book: Cheapest Quintile of 500 Stock Universe\* to S&P 500



Source: Sanford C. Bernstein, Pzena Analysis

Let's contrast this opportunity with where we stood at the end of the last powerful anti-value cycle that ended in March, 2000. As can be seen in Figure 4 the absolute valuation of the cheapest quintile of our investment universe today is 0.62x, versus 1.30x in March 2000, or approximately 52% lower. So not only has the broad equity market fallen in value, but there has been an extraordinary, and rapid decline in the valuation of "value" stocks.

This opportunity is also reflected in the valuation of our own portfolios. Figure 5 illustrates the valuation level of our Pzena Value portfolio over the years. At approximately 5.0x price-to-normalized earnings, our portfolio is at the cheapest level in our history. There are only two other periods where we had opportunities almost as attractive – March 2000, the end of the "dot.com" bubble, and in early 2002 during a period of recession and geopolitical uncertainties. Both our history and that of market cycles in general would suggest that valuation plays a critical role at this point, and that it is typically value strategies that lead market performance coming out of a recession. As can be seen in Figure 6, the cheapest quintile of valuation has provided a significant level of excess return in the year following a market bottom. Although we make no pronouncements as to timing of the bottom, we believe that our portfolios are well positioned to participate once the upturn occurs.

### Summary

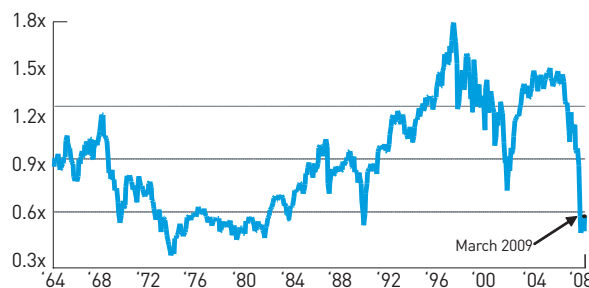
Patience has become a rare commodity in the investing world, but it may be one of the most powerful tools an investor has available today. History suggests that current valuation levels should ultimately provide the patient investor with strong outperformance as current stresses abate, and uncertainties are resolved. We look forward to seeing such patience rewarded. ■

### DISCLOSURES

*Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.*

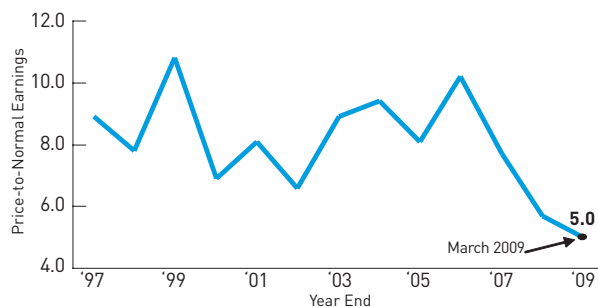
*The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.*

**Figure 4: Large Cap Valuations at Early 80's Levels**  
Cheapest Quintile of 500 Stock Universe: 1965 - March 2009



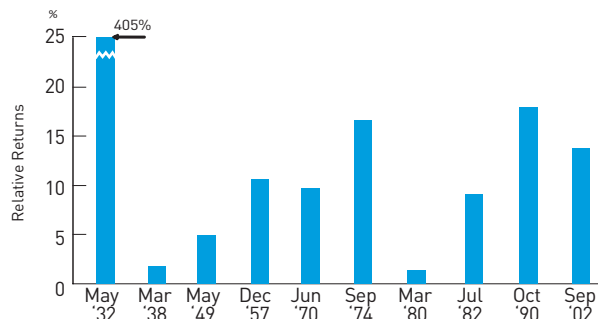
Source: Sanford C. Bernstein, Pzena Analysis

**Figure 5: Pzena Value Portfolio Absolute Valuation Level is Extreme**



Source: Pzena Analysis

**Figure 6: Cheap Stocks Typically Win Big After Market Bottoms**  
Cheapest Quintile of Valuation\*  
Relative Returns in the Year Following a Market Bottom  
1926-2008



Source: Empirical Research Partners Analysis  
\*Large-capitalization stocks; equally-weighted data based on multivariate framework  
Cheapest quintile of large cap price-to-book prior to 1950