DEJA VOODOO

ONE OF THE MORE INSIDIOUS INVESTOR BIASES IS A natural tendency to assume that the future will look like the recent past. Behavioral-finance experts call it "recency bias." Ordinary folk call it "investing with a rearview mirror." It helps explain why two years ago most economists were calling for sunny skies ahead, why some money managers were saying company balance sheets were irresponsibly underleveraged and why so many hedge fund managers had come to the conclusion that short-selling no longer worked.

The best investors don't fall into this trap. Take Julian Robertson, famed hedge fund manager, now a billionaire philanthropist at age 77. We spoke to him in November 2006, and at the time he warned us of the "insanity" he saw in the stock market.

"You toss the housing debacle out as if it were nothing! The Internet bubble affected a few of us, but the vast majority of Americans were not fazed by that. Now you've got people living on the refinancing of equity in their homes, and almost all of us own homes," said Robertson.

He went on, "Think about what happened in Japan in the 1990s. Their stock market went down [60%] during a period in which our market was up four times. Those are huge relative figures. But Japan was hardly fazed by that. Why? Because all their people have a wad of savings. Here, all our population has a wad of debt. So the consequences of a housing bubble bursting could be enormously serious here. The market's not pricing that in."

Robertson saw what others missed in part because his years of perspective gave him a representative enough sample of past experience to be useful. Ray Dalio, founder of money management giant Bridgewater Associates, makes a similar point in his recent letter to investors: "If you optimize your investment strategy to work in a certain period without having a deep enough understanding of how it would work in all circumstances, including circumstances that did not occur within the period that's your frame of reference, you will inevitably do very badly. That is what happened to a lot of people in 2008."

Recency bias, of course, can deflate a stock's price as well as it can inflate it. Not even the bluest of blue chips is immune. Take **Berkshire Hathaway (90,950, BRK.A)**, now selling for 30% less than its price only a year ago. Investors seem to assume that the current state of affairs will deteriorate and never improve.

We calculate Berkshire's intrinsic value by adding the value of its operating businesses to the market value of its investment portfolio. If we assume that investments, valued at $77,793 per share at the end of 2008, have fallen in line with the 6% market decline, they're worth $73,125 per share today. The operating businesses should generate $5,000 per share in pretax earnings in 2009—down from $5,700 per share last year. Putting a multiple of eight on those earnings adds another $40,000 per share in value. That makes Berkshire's intrinsic value today $113,125 per share, 24% above the current price of $90,950. It's a buy.

American Express (20, AXP) is also suffering from a myopic negative bias. The stock (whose largest shareholder is Berkshire) fell below $10 in March but now sells for $20. There are two questions overhanging Amex: Will it weather the financial storm, and if it does, will it ever return to the profitability it has enjoyed in the past?

Recency bias can deflate a stock's price as well as it can inflate it. American Express is suffering from a myopic negative bias.

Amex's model is focused on attracting people who spend more per card, which in turn allows Amex to charge higher fees to merchants. The company then invests in rewards and other perks for its cardholders, and this attracts more high-end card members. This virtuous cycle is one reason Amex has a ten-year average return on equity of 30%. Since 1960 American Express' price/earning multiple has mostly ranged between 14 and 22. Today, even after doubling from its low, the stock sells for less than 8 times trailing earnings.

In response to the current crisis, Amex acted swiftly to safeguard its liquidity, securing federal bailout money, selling government-backed CDs to customers and laying off 7,000 people. We estimate that even in a bleak 2009 the company should earn $600 million, or 50 cents a share. That's a far cry from the $3.45 it earned in 2007, but as long as the company remains profitable, it shouldn't need to raise capital and dilute shares.

When the economy picks up, American Express should be able to earn at least a 20% return on equity. This translates to earnings per share of $2 to $3. At a normalized multiple of 15, American Express' fair price becomes $30 to $45. A good long-term memory and a little patience can have their rewards. F

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