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Mr. Market

At the end of a recent big down day, an exasperated friend and fellow investment professional threw up his hands in frustration and exclaimed, "I hate the stock market!" As it turns out, the companies he owned shares in were actually doing quite well, but their share prices had fallen sharply due to a string of bad economic news. His exasperation got me thinking about the stress that a mostly good thing— an active market for buying and selling— can cause. Note that my friend said he hated the stock market— not the companies he owned shares in, but the market in which they trade. Over the past few years I have overheard many people say something similar. Sometimes it is phrased "I don't trust the market" or "I don't like the market" or "I don't want to be in the market." Do not worry, this letter is not an attempt to get you to like or trust the "market." This letter is about the nature of the market and how, as long-term investors, we can turn the volatility of the market in our favor.

Benjamin Graham, the father of value investing, shared the following parable in his classic book, The Intelligent Investor, to help investors understand the market and how to use its manic behavior to their advantage. It was first published in 1949 but Graham's story offers insight that may be even more valuable today.

> *Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*
>
> *If you are a prudent investor or a sensible businessman, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him*

or in case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

Benjamin Graham's parable makes taking advantage of Mr. Market sound simple, and it is relatively simple, but it is not always easy. Perhaps an appropriate analogy is the process of losing weight. Everyone knows how to accomplish this: eat less and exercise more. However, it is more fun to eat junk food than vegetables and it is much easier to sit on the couch and watch television than it is to go to the gym. Taking advantage of Mr. Market requires doing lots of tedious homework on how companies are performing and their prospects as well as resisting the pull of Mr. Market's emotional swings.

Mr. Market cannot be taken advantage of if the price information he offers triggers emotional buy or sell decisions. His mood swings are only beneficial to those who do their homework and understand the value of the assets being traded. Price information without the context of value is just noise that triggers emotion— big jumps spark eager feelings of greed and big drops bring on a dreadful fear of loss.

Mr. Market has been more volatile than warranted by changes in underlying value since assets began trading long ago, but over the last few years he seems even more temperamental than usual. Following the bursting of the housing bubble and the onset of the banking crisis he cut his asking price by more than 50%. Not much later he was feeling better and raised his asking price over 100% only to get spooked again recently and cut his price by nearly 20%*. These wild swings have been enough to frighten off many reasonable people that do not have the time or inclination to dig into the numbers and assess underlying values.

The market is in reality not a person, of course, but an auction and auctions involve an inherent lack of predictability. It is hard to say what the highest bid will be for any given asset on any given day. Auction prices are a function of the behavior of crowds and from time-to-time crowds gain a collective momentum which herds the majority in one direction or another for reasons that are sometimes hard to identify, much less explain.

Benjamin Graham used his Mr. Market parable to make the point that the same volatility that causes stress and heightens perceived risk also creates opportunity for patient investors who work to understand the value of underlying assets. Graham's most famous student, legendary investor Warren Buffett, has long employed what might be called a "Mr. Market" approach to investing in stocks. During the last few years, as Mr. Market has been especially fretful, Mr. Buffett has paid premiums over Mr. Market's asking price so that his holding company, Berkshire Hathaway, could take all the outstanding shares of Burlington Northern and Lubrizol off Mr. Market's hands.

With all the market price volatility of late, it is easy to lose sight of the income implications of buy and sell decisions. Recently, many investors have piled into cash and gold. Currently, cash pays almost no income and, according to a recent statement from the Federal Reserve, will likely pay very little until at least mid-2013. Gold, a very popular asset right now, pays no income at all. In a low interest rate environment, well run companies that pay growing dividends may be a significantly more attractive option for investors seeking income. Fortunately, Mr. Market's current pessimism provides an opportunity for investors to buy quality companies with a record of increasing dividend payments through thick and thin at prices that are, in many cases, below levels of the late 1990's.

Back in 1999, Mr. Market was optimistic about the future and confident that the internet would drive an economic boom for years to come. The S&P 500 traded at an earnings yield of less than 2.5%*. At the same time, cash paid better than 5.0% and the price of gold averaged less than $300 per ounce. Today, Mr. Market is pessimistic about the future and worried that global financial problems will perpetuate economic gloom. The S&P 500 is currently trading at an earnings yield of more than 7.0% while cash yields next to nothing and gold recently traded above $1,800 per ounce*.

Mr. Market's wild mood swings can be disconcerting, especially for investors who only follow stock prices and do not keep informed about underlying business performance. However, these swings can provide opportunities for investors who do their homework. By accumulating strong cash flow producing assets while Mr. Market is especially fearful, investors can enhance their income and put themselves in position to reap additional rewards down the road. If history is any guide, it is unlikely that Mr. Market's current gloomy disposition is a permanent condition.

Thank you for your trust and confidence.

Phil McCauley III
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