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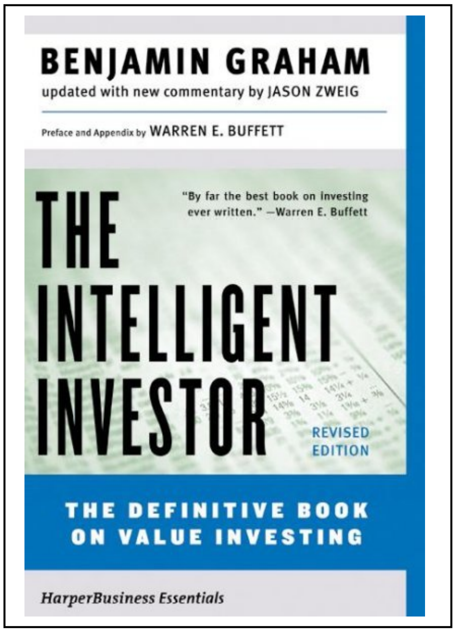
ASSET MANAGEMENT

A Fire Drill for Market Volatility - Will You Self-Inflict Unnecessary Wounds?
Part II: Mr. Market

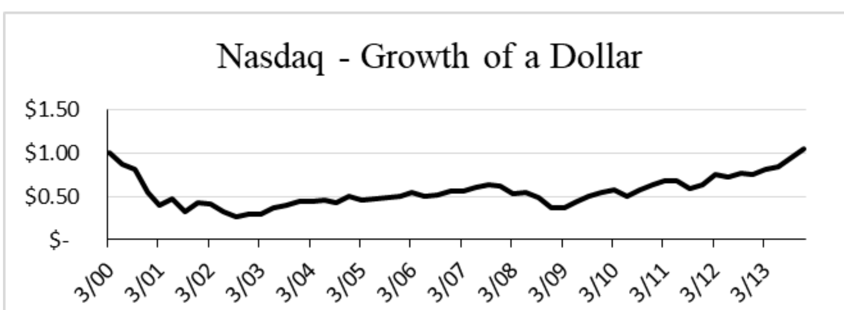
In this second installment of a three part series, we examine the irrational nature of "Mr. Market" and discuss the ways its bipolar nature could be a detriment or could be used to your advantage.



In the book *The Intelligent Investor*, Benjamin Graham used a fictional character ("Mr. Market") to illustrate the irrational nature of publicly traded financial markets. Graham was a teacher and mentor of Warren Buffett. Buffett has referred to the bipolar nature of Mr. Market, noting how his mood can swing from euphoria to quickly change course and emulate Charles Dicken's Mr. Scrooge: "Bah! Humbug!"

When Mr. Market's mood is euphoric, the risk of falling victim to the cognitive bias of overconfidence is magnified. Eventually, over a time period that is difficult to predict, Mr. Market's mania is brought back to reality and companies are once again valued based on fundamentals (i.e. the amount of cash generated on the capital under each company's stewardship). In the late 1990s, Mr. Market's euphoria led to the price of internet related equities soaring skyward like a helium balloon, defying fundamental valuation principals. A $10,000 investment in Yahoo on December 31, 1999 entitled you to a paltry $3.06 of earnings or roughly 3,264 times its earnings. The financial press and some burgeoning investment "experts" were speaking of a paradigm shift that deemed traditional valuation methods to be as outdated as a disposable camera is today. Confirmation bias[1] was a real risk as the growth-centric NASDAQ market moved higher nearly 60% of the days between January of 1999 and March 31, 2000.

In short order, Mr. Market's manic mood shift ushered out euphoria and in "Bah, Humbug" as valuations plunged when forecasted earnings of many growth companies imitated the Great Pumpkin for Charlie Brown the morning after Halloween. As demonstrated in the chart below, $1.00 invested in the NASDAQ index during Mr. Market's euphoria on March 31, 2000 (near its peak) had declined 74% to a value of $0.26 by September 30, 2002.



Source: Nasdaq Index Performance from Bloomberg 9/24/2019

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Those investors who did not lock in a permanent loss of capital by selling as valuations declined had to wait nearly 13 years to see price levels that allowed for a recovery of their initial $1.00 investment. Some investors in this area of the market are still waiting for their initial investment to be recovered. For example, Intel Corporation, a worldwide market leader in semiconductor chip manufacturing, traded at just over $74 per share or roughly 57 times its earnings in August, 2000. Nearly twenty years later, Intel's stock price has never recovered and recently traded at $57 per share or 12.16 times its earnings (ttm). There are many other well-managed companies that lured investors to pay exuberant prices for their expected growth that trade at similar or lower prices today as compared to two decades ago.

While EBS did not hold any technology stocks in early 2000, we did invest later when we deemed valuations to be more reasonable. The 2000 time frame for technology stock valuations was for us a red light despite the vast majority of market participants seeing a very bright green light. We saw red because our investment philosophy kept us focused on the difference between price and value, looking for Ben Graham's "Margin of Safety." (We haven't always been right however and for a history of our best and worst margin of safety see Exhibit A.)

In our view, there are several key takeaways from Graham's Mr. Market parable:

- Price and value can be aligned for long periods but at times they will diverge.
- Taking advantage of disconnects between price and value that arise from Mr. Market's emotional nature is hard because of behavioral tendencies, such as those discussed in Part I of this series.
- A ratings driven media can assist in distorting investment prices by fueling positivity or gloom. This in turn can bait long-term investors to focus on daily price changes that are irrelevant to those with no plan to buy or sell equity investments in the short term.
- At times of extreme market mania, it is important to maintain focus on the fundamentals that can ultimately drive valuation and enhance long-term investment success.
- Get comfortable doing what is uncomfortable when the market enters one extreme or the other… the media will encourage the opposite.

We decline to forecast future market performance, especially in the short-term. Rather, we focus on the difference between price and value to pursue a margin of safety against the unpredictable bi-polar mood swings of Mr. Market. Historical evidence indicates that future returns are influenced by current price-to levels. In other words, high valuations generally equate to lower future returns while low valuations generally equate to higher future returns. Today, one might argue whether Mr. Market is too cautious, too euphoric, or somewhere in-between. In Part III we will address that question and some additional considerations to assist in planning for the future.

[1] Confirmation bias is defined as the tendency to interpret new evidence as confirmation of one's existing beliefs or theories.

Market and economic data has been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.