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Thoughts for Investors

Voting Machine Versus Weighing Machine

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The stock market has recovered handsomely [the Dow Jones Industrial Average (DJIA) is up over 125%] from those dark days in 2009 when many were predicting the end of the economic world. Like the great value investor John Templeton's admonition that "people don't stay pessimistic forever," many investors have capitalized on the stock market's rise. Yet what puzzles many, especially those still on the sidelines, is that the worldwide "economy" has not recovered despite, or maybe because of, government's profligate spending, money-printing and in some circles corruption. "The stock market's rise is not justified" investors sigh, ... and worse yet, it is only setting us up for a correction or another economic collapse. It is surely another bubble."

"Markets can remain irrational longer than you can remain solvent."

— John Maynard Keynes, economist

Countering the bubble argument is the Efficient Market Theory (EMT). For years, academics and even some investors, have argued that the stock market is efficient because it prices in "all the known information." If this theory is correct then the stock market today is accurately valued. Do you believe that? Or are we at the top of the market and it's time to get out? Of course I don't have the answer and in reality, only one investor will ever get out at the very top just as only one investor can get in at the very bottom. Everyone else gets in and out somewhere along the way, those entry and exit points are determined by your needs, goals and emotion. Your decision as to whether to sell a stock or get out of the

stock market entirely (or maybe even whether to get in) should indeed be based on "all known information" such as a stock's "fundamentals" as well as economic and political factors. Yet it should also be based on recognizing Benjamin Graham's observation that "the stock market is a voting machine not a weighing machine," which I will explain in this newsletter.

"If you are shopping for common stocks, choose them the way you would buy groceries, not the way you would buy perfume." — Benjamin Graham

Benjamin Graham, the father of value investing, observed, as have many investors, that stock prices sometimes bore no resemblance to their perceived value. He then famously explained that "The stock market is not a weighing machine, on which the value of each issue is recorded by an exact and impersonal mechanism, in accordance with specific qualities ... The market is a voting machine, whereon countless individuals register choices which are the product partly of reason and partly of emotion." Ah, emotion. A person who voted for the winning candidate or had invested in 2009 will call their actions reasonable and rational. Those who voted for the losing candidate or those worrying that the market is too high today call the actions of the former unreasonable and emotional. Thus it will always be. A key to investing is to understand when emotion overpowers fundamentals. When investors started to compare two very different companies, Apple and Exxon, earlier this year, emotion and the voting machine were in control just as they were when

panic dominated the stock market in 2009 and many voted to get out at the bottom.

“In the short run, emotions drive stock prices while in the long run fundamentals drive them.”

— John Templeton

So why do investors “vote” instead of “weigh”? The simple answer is that voting is quicker and takes less work than weighing. Many investors cast their vote without doing much of any heavy lifting. Do you know the market potential for every stock in your portfolio? What are their barriers to entry by competitors? Who is their management team? What are their revenues, profitability and pricing power? Is their business scalable? Or do you simply “vote” for them because you like the company and use their product, or because everyone else seems to be buying or recommending the stock? When voting, you can’t make an arithmetic “mistake” because it involves your “feelings.”

In contrast, “the long run” requires continual weighing and reweighing. It involves controlling one’s emotion and even striving to be unemotional. When weighing, there is often a chance you will be wrong, and worse yet, wrong by yourself (a lonely feeling). Weighing also includes elements of time and patience, like planting a seed and not knowing when or if it will germinate.

If a stock does “germinate,” investors are often told to sell it if it has reached a “target price” which supposedly signals overvaluation or an exhaustion of its potential. Yet much of the time that logic seems to be based more on the fact that the stock price has risen substantially than to a real explanation of how it is overvalued or why it is lacking any additional potential. If different firms have different target prices for the same stock, how do you know who is correct? If a company’s business is growing (more customers and more sales to existing customers) doesn’t the stock deserve an even greater valuation and a higher stock price? I’m sure you can think of examples where you “voted” to sell much too early

(not wanting to risk “giving up all your gains”), whereas had you “weighed,” you might have kept the stock much longer. Making the job even more stressful, media attention often focuses on how the “vote” is going, i.e., the daily up and down volatility of a stock or the market as opposed to an in-depth analysis of a stock’s “weight.” It’s no wonder, as Templeton observed, investors are short term and emotionally oriented when investing. As I have said in the past, if you are not up to the hard work of weighing, hire someone who is.

“The investor’s chief problem – and even his worst enemy – is likely to be himself.” — Benjamin Graham

In summary, few believe they invest emotionally. Most believe they invest rationally, “weighing” the potential of every investment. Graham and Templeton who were legendary in their ability to accurately “weigh” the potential of a stock were also legendary in their observation of the presence and effect of emotion/voting on the stock market. In strictly emotional terminology, Templeton offered the following rule of thumb. For 30 years it has helped me understand where, in the continuum of stock market cycles, investor emotion currently stood. “Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.” Today, where you stand emotionally, and where you think other investors stand, will likely determine the “vote.” Only in retrospect was it clear that while pessimism ruled in 2008-2009, many stocks’ “weight” was more than it appeared. Today the “bulls” are winning the vote and some stocks’ weight might be overestimated. Are we euphoric though? I doubt it since there are still pessimistic and/or skeptical investors out there. The last time “euphoria” was evident was in the housing market in 2007, or more recently the euphoria over Apple stock or gold.

Even if the stock market's "vote" swings to the negative someday, when your research identifies a company with "weight," don't be afraid to invest, because in the long run, the scales should tip your way and even the "votes," or should I now say "tweets" will follow suit.

"Individuals who cannot master their emotions are ill-suited to profit from the investment process."

— Benjamin Graham

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Hear the Other Side

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If you would like to discuss the topic of this newsletter, or our team's approach to investing, please feel free to contact us by email at al.boris@alexbrown.com.

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