Stock Market Review

Introducing Mr Market

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Benjamin Graham, the mentor of Warren Buffett and widely considered as the "father" of value investing, wrote a parable in his famous book "The Intelligent Investor" published in 1949 about an imaginary investor called "Mr Market" to explain the movements of the stock market.

In the parable, Benjamin Graham explains that investors should look at investing in shares as buying a part of a business. The only difference is that instead of buying the entire business, an investor only buys a very small stake. Benjamin Graham says that investors should imagine that Mr Market (the partner in the business) would offer to buy someone's share in the business or to sell his own share to them at an established price every day. At times, Mr Market's idea of value seems to be justified by the developments and future prospects of the business. However, more often than not, Mr Market is either feeling very enthusiastic and optimistic or at times fearful and pessimistic. These dramatic mood swings result in a very volatile price quoted by Mr Market from one day to the next.

Benjamin Graham argued that this irrational behavior by Mr Market provides opportunities for wise investors. Such investors should be happy to sell their stake to Mr Market when he quotes a very high price and should be willing to buy Mr Market's shareholding when he quotes a low price. However, rather than determining the value of the business based on Mr Market's price, investors should form an opinion based on full reports from the company about its operations and financial position and the dividend returns that can be produced.

Benjamin Graham used this parable to demonstrate the point that a wise investor ought to choose investments based on their fundamental value rather than on the opinion of others or the general direction of the markets. However, market fluctuations should not be ignored as they can prove to be a valuable indicator that something is either going right or wrong and as Benjamin Graham stated in his book, fluctuations "provide an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance significantly".

It is almost impossible to time the market and many investors who try to do this inevitably buy when the market is high and then they sell when the market crashes. Equity investors should have a long-term perspective in mind and only invest in solid and profitable companies at low prices which will continue to create wealth over time and produce an adequate return. Long-term investors need to look at the future earnings performance of a company rather than what the overall mood may be implying.

The parable of Mr Market can be used to explain various movements in the markets over the more recent years starting off with the technology boom in 1999 and 2000 (when investors were purchasing shares in companies which were either loss-making or with price to earnings multiples above 100). Likewise, the recent sharp slump in 2008 and early 2009 following the demise of Lehman Brothers caused strong panic selling across equity markets and this also led to investors disposing of shares with very low multiples simply because the market's mood was overly pessimistic.

A good example was the downturn in the share price of Apple Inc from over $180 in June 2008 to a low of $82.33 on January 16, 2009. Just over three years later, the share price rebounded by over 500 per cent to an all-time high of over $500 per share as the company's brand and product innovation led to significant leaps in the company's profitability with earnings per share surging from $5.48 in September 2008 to $28.05 in September 2011. Likewise, the same can be said for some of the more cyclical companies such as the major mining firms which had seen their share prices drop below net asset value and at times also below the cash available on their balance sheet! The long-term investors who performed proper analysis and understood the company's fundamental strengths and who were prepared to ignore the "noise" in the market, are now seeing the benefits of this value investing philosophy.

Locally, the two major bull markets on the Malta Stock Exchange occurred in the year 2000 and again in 2006 when trading activity across the equity market surged mainly on a "feel good factor" leading to the price to earnings ratios of most companies rising to unexplainable levels. The p/e multiple of the two major banks had exceeded 30 times in 2006! These significant upturns were naturally followed by bear markets when some of the fundamental ratios then dropped to extremely low and opportunistic levels with a p/e ratio of below nine for BOV in 2008.

One can also use the parable of Mr Market to try to explain the recent underperformance of the local bourse which dropped to a 30-month low last week at a time when many of the major international equity markets have rallied strongly from their October 2011 lows.

History has shown that over prolonged periods of time, share prices generally recover when the market returns back to its "senses" and equities then begin to properly reflect their long-term profitability prospects.

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What could explain the share price slide in some of the local companies to all-time lows? Is this based on the very pessimistic behavior of Mr Market or has there been any major announcement reflecting a significant downturn in the future prospects of the business? With the exception of Go plc's equity which has tumbled to consistent fresh lows in recent months reflecting the major macro-economic difficulties in Greece and the serious challenges being faced by the telecom company Forthnet SA, it is very questionable whether the downturn in some other equities are reflecting a lower fundamental value or simply are a result of fear among some investors.

In order for investors to try and distinguish whether a drop in a share price is as a result of market pessimism or due to a significant negative development affecting the future business potential, they would need to carry out an analysis of a company's financial statements and obtain other information from the annual reports and other periodic announcements. This, however, may prove to be difficult and too time consuming for many investors.

Therefore, they would need to depend on research analysts who base their recommendations on the fundamental strength of the company after analysing the financial statements and better still organising regular visits to companies to question the top management to obtain further information and insight into the strategic developments going forward. In this respect, local public companies need to emulate what takes place overseas and be more forthcoming with information and provide more regular updates to help investors and market participants to gain a better understanding of their current business conditions and long-term future profitability prospects.

Many of the world's greatest investors such as Benjamin Graham and Warren Buffett explain that it is precisely in times when investors are deeply traumatised that the best opportunities are available in the market. This is exactly what Warren Buffett practiced in 2008 and 2009 when he purchased additional shares in various companies including the US rail operator Burlington Northern Santa Fe, General Electric and Goldman Sachs. He repeated this only a few weeks ago following a sharp decline in the share price of Tesco plc.

Over the years, history has shown across both the local and international equity markets that over prolonged periods of time, share prices generally recover when the market returns back to its "senses" and equities then begin to properly reflect their long-term profitability prospects.