

Price Matters

In one edition of the classic book, *Securities Analysis*, famed investor Benjamin Graham used an example of one “popular” and one “unpopular” stock to make a point about how important price is to future returns. It just happened to be the same company during two different periods of time.

One period was that of high expectations and a bright future. The other involved heightened concern and a clouded outlook. In 1939, the stock, known today as Boeing, was selling at \$45 with a book value of \$10 and had a positive outlook. In 1947, the stock was selling at \$25 with a book value of \$40, however, there was great uncertainty surrounding the economy and the business. If you bought the stock in 1939 you would have done poorly over the next several years, while if you had bought when the stock was selling at a discount to its asset value, you would have done well.

What many investors fail to understand – including professional ones – is that potential return is determined by the price paid, in addition to the fundamentals of the business, market and economy. That is, the potential return and risk of a security can be high at one price, moderate at another, and low at a third price.

Anyone can identify whether one company or industry has better prospects than another. However, when you take into consideration price, it’s not so clear anymore which investment will work out best. Price is what creates incremental return.

In 1999 the NASDAQ rose 85.5%, yet stocks with actual earnings on all the U.S. exchanges lost 2% on average for the year. That same year, those stocks on the broad U.S. exchanges without any earnings (i.e. only losses) rose on average 52%. Clearly that was as absurd as it was unsustainable. As the markets were rising, so were the risks. As Ben Graham stated, “the danger of paying to wrong price is almost as great as that of buying the wrong security.”

Great companies are not great investments unless you buy them at the right price. Capitalism has a great way of turning a good idea at a low price into a bad idea at a high price.

Disclosure:

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter (article), will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter (article) serves as the receipt of, or as a substitute for, personalized investment advice from TJT Capital Group, LLC. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.

While the herd of investors were clamoring for technology stocks in the late 1990s, a barrel of oil was selling in the “teens,” real estate investment trusts (REITs) were selling at roughly 75% of replacement value with dividends north of 8%, and value stocks were deemed by the crowd to be old relics. Too often these stocks were being discarded to chase technology shares.

In 2000, after an eighteen year bull market produced a 1409% return and the highest price/earnings ratio on record, the book “Dow 36,000” was written. Unfortunately, history shows that many of the deep declines, including 1929, 1973-1974, 2000-2003, and Japan in 1990 had their origin in rich valuations.

Between 2000- 2006, according to Yale economist Robert Shiller, home prices, adjusted for inflation, increased a staggering 80%. This had no precedent in the U.S. over the past 100 years. Given a growing amount of the advance was fueled by no money down mortgages, it was destined to end badly.

Successful investing is not a popularity contest. Andrea Frazzini of the University of Chicago and Owen Lamont of Yale analyzed inflows into stock mutual funds and the individual make-up of the funds from 1980 -2003. For every period from three months to five years, the most popular performed significantly worse.

Warren Buffett has commented that the most common cause of low price is pessimism, sometimes pervasive, sometimes specific to a company or industry. He wants to do business in such an environment, not because he likes pessimism but because he likes the prices it produces. It’s optimism that is the enemy of the rational buyer.

Warren Buffett’s mentor, Benjamin Graham, said “you are not going to get good results in securities analysis by doing the simple obvious things of picking out companies that apparently have good prospects.” His point was that, often times, the good news is already priced in. It would be the equivalent of purchasing Boeing in 1939.

One of the great paradoxes of investing is that when conditions feel most risky, they are generally less so if the perception of risk is priced into the value of the security.

Investing by consensus assures a consensus-type return. If you buy the same securities as others and invest the same way, you will have the same results. As the late John Templeton stated, “It’s impossible to produce superior performance unless you do something different from the majority.”

We at TJT Capital Group want to help you make better investment decisions.