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Avoiding the Mood Swings of Mr. Market

Price is what you pay, but value is what you get.

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"Something is worth what someone is willing to pay" is an adage I often heard in my early career as an investment banker.

At the time, it seemed reasonable and embarrassingly obvious. But as I reflect on my personal experience, I see that there have been many times when I paid more than something was worth and, conversely, I've purchased things worth more to me than I paid. Indeed, buyers and sellers often make mistakes in judging how much they are willing to pay versus what they "should" pay, thus revealing the flaw in the "price equals value" adage.

It wasn't until I came across Benjamin Graham's famous allegory of the stock market, involving a character named "Mr. Market," that I gained a new perspective: "Price is what you pay, but value is what you get."

To summarize, Graham describes Mr. Market as a business partner who comes knocking on your door every day, quoting a price to buy or sell shares of the business you both own. You are free to buy more or sell some at his offer price. Or you can ignore him entirely, knowing he'll be back the next day to quote another price. Usually the price seems reasonable, but on occasion it can seem absurdly high or low.

Graham describes Mr. Market as emotionally unstable. He's subject to extreme mood swings ranging from manic highs to depressive lows. Those swings are reflected in the prices he quotes. Even when the value or underlying economics of the business remain steady, he will quote prices that fluctuate, sometimes wildly, from day to day.

To be sure, the many CFOs mystified by the irrational fluctuations of their own company's share price when nothing at all is happening inside the company can relate to this description of Mr. Market.

In the stock market, valuation multiples such as price to earnings (per share) act as the conduit for investors and observers to connect price to some indication of value. The term "valuation multiple" is a bit of an oxymoron, however, given that valuation multiples are pricing models, not valuation models.

The magnitude of the asset bubbles and bursts that have happened throughout history suggest that discrepancies between price and value can be anything but trivial. Among the most recent examples: the tech bubble of 2000 and the real estate bubble in 2007, which respectively resulted in market capitalization losses of $5.4 and $6.1 trillion for the S&P 500 alone.

When market prices are high, valuation multiples, which are generally benchmarked against peer companies facing similar investor euphoria, are used to determine a "fair value" that may not be fair at all. The same holds true when market prices are low. This perpetual cycle of price determining value leads to massive swings and cycles and market mistakes. But those would effectively disappear if assets were priced to value rather than being valued on price.

If investors truly distinguished value from price, multiples would be higher at the bottom of the cycle, in anticipation of the up cycle, and vice versa at the top. Price-to-book ratios should hardly be affected.

However, that's not the way it works in the real world. Investors get scared and multiples tend to go down at the bottom of each cycle, and the opposite happens at the top. The same holds true in the strategic planning discussions at many companies. More acquisitions are made at the height of the market, when greed is prevalent. Assets are sold at the bottom of the market when fear has taken over. As a result, acquisitions tend to be expensive and have gotten a bad rap.

In fact, our capital market research has shown that acquisitions can generate a significant amount of value for shareholders, when done correctly (See Acquirer TSR Hinges on Economic Results). Yet although most people would agree with Warren Buffett's motto that it's more profitable to "become greedy when others are fearful and fearful when others are greedy," few really act on it. The difficulty is that humans have emotions, and these emotions can make it difficult to distinguish price from value.

At the same time, confusing price with value doesn't only affect investors. The confusion can creep into corporate offices as well. Rarely do we come across a management team that believes their company is overvalued. In fact, many tend to believe their company is undervalued, citing higher trading multiples of other companies within their industry. This perceived pricing error is often attributed to an investor "value recognition" problem rather company "value creation" problem.

But focusing on investors' inability to recognize the company's value has two critical assumptions embedded within it. First, it assumes that the valuation multiple in question captures all key attributes that drive value differences among peer companies. That's generally not the case. For instance, the earnings in a price-to-earnings ratio don't capture differences in growth or reinvestment needs among peers that can drive pricing differences.

Second and most importantly, "value recognition" assumes that the market prices of their competitors used to calculate the valuation multiples were in fact "fairly valued" in the first place. Perhaps Mr. Market was having one of his mood swings and was overvaluing the entire peer group.

In any case, when value recognition is blamed for a languishing share price, an investor relations campaign can quickly turn from a genuine attempt to communicate the company's value to simply promoting the share price and driving market expectations higher. Companies embarked on that course of action soon find themselves on a treadmill on which market expectations become higher and take on a life of their own. The faster the treadmill gets, the tougher it is to get off. Similarly, when prices increase due to higher expectations without the hard work to create value to justify those expectations, the temptation to simply fuel expectations even higher increases.

This results in short-term tactics intended to keep the stock afloat, while destroying long-term value in the process. When management teams mistake price for value, they sometimes make large, overpriced acquisitions that create the appearance of revenue or income growth year over year. Or they buy back shares at the top of the cycle to push up EPS. Or they spend more time each quarter deciding how to spin the prior quarter results, rather than planning how to grow the value of the business.

Ultimately, market expectations and valuation multiples outpace the value generated by the company. A violent correction typically ensues, which not only devastates shareholders, but can also lead to bankruptcy if capital markets lose trust in the company.

In stark contrast, management teams that truly understands the distinction between price and value exhibit entirely different behavior. They consistently apply the simple but elusive rule of "buy low and sell high." They either consciously, through a measure like Economic Profit, or unconsciously know how to measure, recognize, and create value when they see it. They typically employ a disciplined, rules-based approach to capital management and deployment. In it, both the profit from the income statement and the capital on the balance sheet from which profit is generated are taken into account.

Becoming a company that distinguishes value from price begins with an honest self-assessment. What companies say they do and what they actually do are not always the same. Self-awareness starts by looking back at past valuation decisions to determine whether value was actually created or destroyed. It also involves gauging whether market prices were used to value the decision or whether value was used to determine the price.

Such an assessment gives managers the clarity of mind to recognize when it's better to buy back shares, issue a special dividend, or reinvest in the business. The management team that truly understands the difference between price and value recognizes that a share price that's overvalued is just as bad as one that's undervalued. They much prefer a stock price that tracks closely to value, knowing they're more likely to attract longer term investors who seek to profit from the value that's created rather than from the investment mistakes of other shareholders.

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