

Junk bonds end up a safer bet because, given those relative levels of borrowing, investors would only lose 9 percent on the securities in a scenario where they post their worst monthly returns since 2011, according to the Citigroup analysts. The damage for Treasuries would be 13.6 percent. . . . “We find some surprising results,” they wrote in the report. “High yield is less risky than Treasuries.”

– Bloomberg News, September 9, 2014

There’s a lot of ways to make money in the oil and gas business, and not all of them involve drilling for oil . . . You just drill investors’ pocketbooks. When investors are willing to throw money at you, you can just make money on that. It’s a time-honored tradition.

– Ed Hirs, managing director at Hillhouse Resources LLC, an independent energy company

Halcon’s August investor presentation for EnerCom Inc.’s Oil & Gas Conference in Denver illustrates how far apart the figures can be. The company told investors it had *resource potential* equal to 1.3 billion barrels of oil. That’s almost 10 times the *proved reserves* it reported to the SEC at the end of 2013. [Italics added]

Asked in the July interview how much faith investors should put in resource estimates, Wilson [Floyd, multibillionaire owner of Halcon] says: “They shouldn’t put hardly any in them. They should just put in the idea that there’s some upside there. And if the practitioners are good at what they do or lucky, that upside might get turned into value.”

– Bloomberg News, September 8, 2014

# “Price Is What You Pay, Value Is What You Get”

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Most investors have likely heard the old adage invoked as the title of this commentary. It's a safe bet, however, that far fewer have thought through its deeper implications. “Price is what you pay, value is what you get,”<sup>1</sup> implies that price and value are not always one and the same. To be sure, its inherent wisdom is not universally embraced. The ubiquitous practitioners of Modern Portfolio Theory and its efficient market hypothesis bristle whenever they hear such utterances from those of us throwbacks who hold the contrary point of view.

“What you get,” intrinsic value, is in simplest form the *discounted* present value of *future cash flows*. The words in italics are variables about which opinions may differ as they involve forward-looking assumptions about discount rates and cash flows. Those assumptions and opinions mean there will always be a degree of imprecision in estimating intrinsic value (“what you get”), but the variability is far less erratic than “what you pay” for securities. The disparate amalgamation of investors and speculators making buy or sell decisions both influence and *are* influenced by markets. This contagious and sometimes emotionally charged combination can excite the manic-depressive tendency of markets, causing extreme and fundamentally unjustified oscillations in market prices, often when least wanted or expected.<sup>2</sup>

Let's assume, for example, the approximated intrinsic worth of a security is \$10. Its price might theoretically fluctuate over a market cycle between, say, \$5 and \$20 (falling 50% below intrinsic worth in percentage terms and rising 100% above), while intrinsic value remains comparatively constant.

But that's only half the story. Just as surely as prices can and do temporarily defy the gravitational tug of value, in the end the hard laws of physics trump the soft science of crowd psychology. The farther prices rise above or fall below their fundamental value, the greater the store of potential energy to be released in the resulting disequilibrium. Once the reversal process begins, momentum develops and markets generally overreact. Does (can?) a swinging pendulum stop on a dime, at its position of balance between the two extremes?

The signature advantage of active capital markets for long-term *investors* is the forum it provides to inexpensively and conveniently purchase or sell securities for 6 ½ hours every business day of the week. Ameritrade and E\*TRADE, which cater to a rather frenetic coterie, would not be in business

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<sup>1</sup> Berkshire Hathaway 2008 Annual Report Chairman's Letter that was posted in March 2009. Buffett wrote: “Long ago, Ben Graham taught me that ‘Price is what you pay; value is what you get.’ Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”

<sup>2</sup> Because of the law of large numbers, the volatility of the S&P 500, the weighted average volatility of 500 stocks, will be less than its most volatile securities. Nonetheless, pricing disparities or anomalies attract attention and, through the process known as arbitrage, traders are constantly buying what they believe to be underpriced and selling what they contend to be overpriced. Thus the expression: “It's hard to find bargains in a bull market.” Conversely, because of the same process, bargains proliferate in the most pernicious of bear markets.

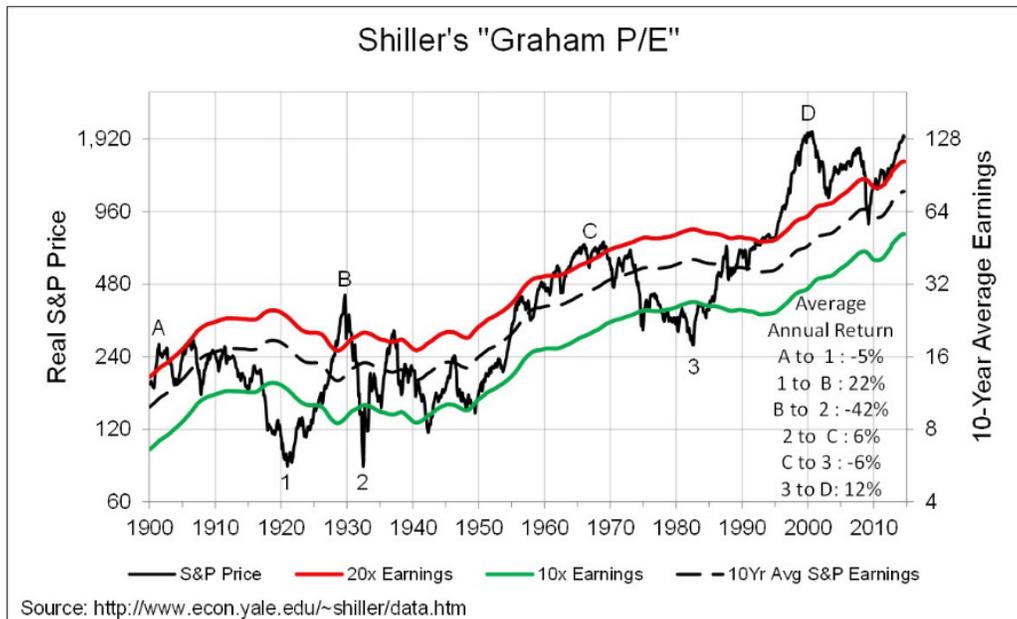
were it otherwise. By accepting or rejecting the “market’s” price at any given moment, an investor is effectively determining the only variable within his control. Investors can’t set prices, but rejecting a bid or offer makes a bold assertion: The amorphous market is occasionally way off the mark in pricing value.

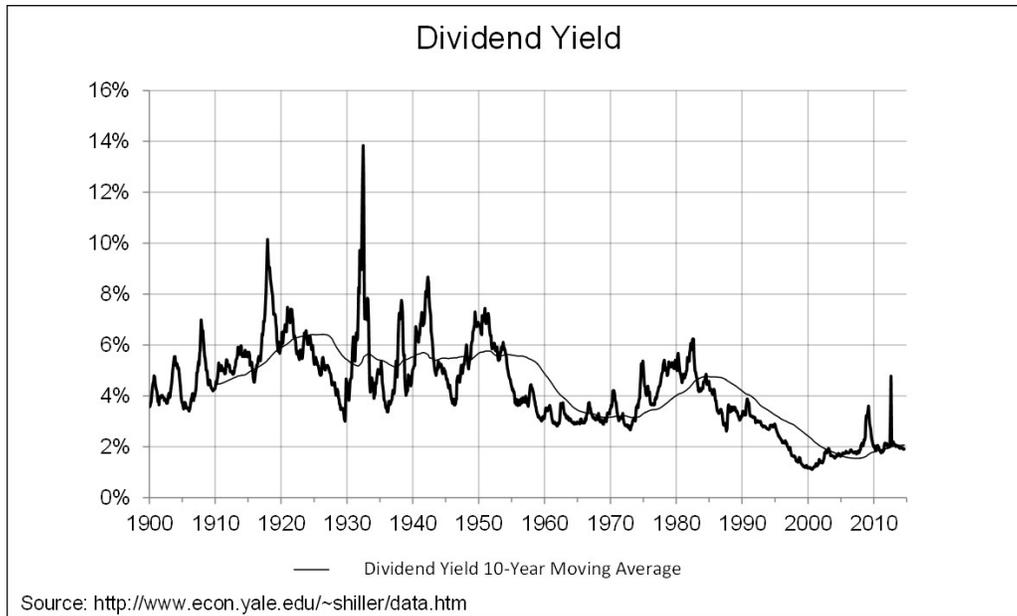
Accepting or rejecting is not so much a discrete decision as it is a process requiring the discipline and skill to screen out the onslaught of the market’s endless noise in search of an occasional meaningful signal. The intrusion extends to smart phones, insidious devices that we empower so that the markets can tempt and taunt us anytime and anywhere. Moreover, rejecting the market’s price incurs an opportunity cost while awaiting a possibly more favorable price at some unknown time in the future. Another old saying can haunt those who wait: “A bird in the hand is worth two in the bush.” Is it any wonder that so few investors are resolute enough to resist surrendering their identity to the clamor, social comfort, and anonymity of the thundering herd? As Ernest Dimmet, author of *The Thinker*, observed, “Nothing is more striking than the absence of intellectual independence in most human beings: They conform in opinion, as they do in manners, and are perfectly content with repeating formulas.”

The miracle of daily marketability goes largely unused by rational, long-term investors. But the flurry of trading activity nevertheless often foments unintended outcomes. It legitimizes Ameritrade or E\*TRADE, both of whose names reveal their true mission – “to trade,” which is not synonymous with “to invest.”

Independent thinkers are encouraged to take a hard look at Chart 1. The price of the S&P 500 is the jagged, solid black line. A defensible approximation of the underlying value of the S&P index is represented by the comparatively stable dashed black line – it is the 10-year moving average of S&P earnings. The red and green lines indicate an index level at which the S&P trades at 20 or 10 times earnings, respectively. [\*Earnings and S&P index values are inflation-adjusted.]

Charts 1 and 2





The purpose of this short essay is not to defend the efficacy of Bob Shiller’s valuation methodology, although that has indeed become a popular topic lately. Since Tobin’s Q and the Market Capitalization to GDP Ratio – each using different metrics – arrive at the same valuation conclusion, the burden of proof shifts to their critics. Nor is this essay of much utility to those who are preoccupied with the short-term. Our valuation tools are far better suited to those who have a strong preference for being generally right than to risk permanent capital loss by being precisely wrong.

Common sense suggests that one gets a much better value for the money by paying \$5 rather than \$20 for the \$10 in intrinsic value hypothetically posited earlier. There are any number of difficult-to-master attributes an investor must have if he aspires to be a player and not a pawn. Among these are: 1) if he’s a buyer, the patience to wait for a price that is at or below the intrinsic value of the security; if he’s a seller, the courage to part with an asset that has made you look good and will surely rise further after your sale to make you look bad, and 2) an awareness of the historical range of market price (i.e., valuation) volatility. See Chart 1. Analogously, the market sells much closer to \$20 today, not \$5.

To address the most immediate question on readers’ minds, one need not invest at or near the lowest points (nor sell at the highest points) in order to earn competitive real total returns from equities in general. The low points simply represent the optimal trade-off between prospective future compounded index returns and the risks assumed *if one believes in mean reversion and believes that risk is a function (positive or negative) of the relationship between the index price and its historical mean*. A savant is one who buys or sells within 20% of the bottom or the top. Most who believe they’re smart enough to recognize and take appropriate action to capitalize on a market top or bottom as it is occurring are likely more idiot than savant.

Chart 1 provides the broad-brush view. For specificity, at the secular lows (points 1, 2 and 3) the CAPE (Cyclically Adjusted Price-Earnings Ratio) was 4.8 in December, 1920; 5.8, June, 1932; and 6.6 in July, 1982.

By contrast, the current CAPE is 26.1 compared to its historical mean of 16.6. [It peaked at 32.5 in 1929 (A), 23.8 in 1966 (B), 43.5<sup>3</sup> in 1999 (C) and, for recent comparison purposes, reached 27.1 in both 2004 and 2007.]

The current dividend yield\*\* is 1.9% (it ranged from as high as 14% in 1932 to as low as 1% in 2000). It should be noted that dividend yields were 6% or greater at each of the low points, thus enhancing the total return *and* increasing its stability because of the low variability of dividend payments. [*\*\*The second chart provides dividend yields for the calculation of total return and for one to observe the inverse relationship between index prices and dividend yields.*]

Every entry point requires an independent, educated, rational, experience-based judgment about the trade-offs then presumed to be present. If one is ill-advisedly fully committed to equities and a subsequent bear market reverses the paper gains and, more importantly, elevates one's aversion to assuming the risk inherent in owning equities even if those risks are historically low, then the paper gains achieved earlier must be considered illusory and thus unearned. Before becoming too sanguine about drawdown risks in the current market, observe from Chart 1 that secular bear markets develop avalanche-like momentum on the downside in the process of mean reverting. It's a long way from 16.6 times – let alone 26.1 times – to the mid-single-digit lows ultimately reached at points 1, 2, and 3. From the end of World War I until September 1925, the Shiller PE languished in the single digits. It did so for only 16 months during the early 30s,<sup>4</sup> but experienced an extended span of single-digit lethargy from September 1977 through January 1985. Those periods during which markets overprice risk and underprice value are the Halcyon Days for investors like us. From the late 70s through the mid-80s, we had more ideas than money. We actually opened margin accounts (said sheepishly). Black swans were effectively priced in, freeing us to focus on the pruning of portfolios; i.e., systematically replacing good investments with great ones.

The zeitgeist of August 1979 was captured in the cover story of BusinessWeek which famously proclaimed “The Death of Equities.” As one might expect, the ranks of buyers were thin. They always are when stocks are cheap.

A subtle marker common to all seven inflection points included in Chart 1 is that those investors and pundits who believed (almost always well in advance of the turning point) a secular change in direction was in the offing represented a tiny and inconsequential minority. We welcome the apparent short-term thinking of the vast majority. Were the cohort of visionaries to grow,

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<sup>3</sup> I am persuaded by all that I've read and have come to know is that the 1999 peak was a historical anomaly, not unlike 1929 – the equivalent of a 100-year flood. Accordingly, I believe the probability that it will recur in the next 50 years appears so remote that it should be excluded from any calculations about the potential upside for valuations in the current episode. Most weight should be given to the "normal" peaks in the summer of 1901 (25.4), in early 1937 (22.4) and February 1966 (24). On those dates the 10-year U.S. Treasury bond yield was 3.1%, 2.7% and 4.6%, respectively. Dividend yields were also below the average of 4.4% at 3.6%, 4.1% and 2.9%, respectively.

<sup>4</sup> One must become quite familiar with the juxtaposition of index prices and underlying earnings, which fell by a third, to fully understand why the index appeared “cheap” for such a comparatively short time.

opportunities to capitalize on extreme price anomalies in bull or bear markets would be greatly reduced.

One possible explanation for what appears to be less than completely rational behavior is that modern-day humans have yet to shed their primal instincts. Today we view money as the near substitute for brute force once necessary to acquire what was needed to survive. Money, so long as it is perceived as a medium of exchange and store of value, permits the deferral of gratification. And yet much of our behaviors reflect our primal hardwiring: Our thinking and behaviors are anchored in the moment. Thus, most people envision the future by simply extrapolating the present. Conversely few, it appears, are able to imagine a future radically different from the present.

With the past as our touchstone, and our human proclivities acknowledged, let's fast-forward to the all-important present. In the process, at the risk of being called a heretic, I must warn of the dangers of unquestioning extrapolation, particularly at possible inflection points. In my judgment, the future will not resemble the present, but rather the past. I think it highly probable that the anomalous secular peak D reached in the late 1990s will eventually cycle through to a secular trough similar in order of magnitude to points 1–3. (The lows reached in the spring of 2009, in my judgment, did not constitute the bottom of the longer-term cycle, which will in due course become point 4).

There is some fragile confidence to be derived from having been among the fortunate minority in 1972, the early 1980s, the late 1990s, and 2004–2007. However, the fact that my views are again as out-of-favor as they were on the earlier occasions does not in and of itself mean that time will prove my conclusion that today's risk/return trade-off is a fool's folly. The only known is that my perspective is contrary to the one commonly held. In medical jargon, my analysis could be a false-positive error: I may have assumed risks to be present that are in fact absent.

Encouragement can be found in Warren Buffett's admonition in the Berkshire 2006 annual report, which I paraphrase only slightly: *Being aware that a single, big mistake can wipe out a lifetime of successes, a wealth manager must be hardwired to recognize and avoid grave risks, including those never experienced before.* Buffett went on to add that, "...fierce independence of thought and action, equanimity of temperament, abiding rationality and a keen understanding of human nature are essential."

Since, true to form, only a handful of investors, which interestingly did not include Buffett, "recognized and avoid[ed] the grave risks, including those never experienced before" that erupted in the Financial Crisis and Great Recession – and fewer still have proactively protected their portfolios today from anything more unsettling than a few bumps in the financial and economic road ahead – I should not be surprised that price momentum has surged longer and higher above fundamental values than I believe justifiable. Like Bob Shiller, featured in the MCM Quarterly Capital Markets commentary from the second quarter of 2014,<sup>5</sup> my resolve becomes stronger the farther prices rise above intrinsic worth.

Conspicuous by its absence in this essay is any reference to the substantial impetus the capital markets have received from the post-2008 Federal Reserve policy regime. Discussed at length elsewhere, would the Shiller PE be at its current elevated level without it? In a similar vein, should one expect to read the anecdotal quotes on the cover page of this essay when the Shiller PE telegraphs acute aversion to risk? Enough said.

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<sup>5</sup> [http://www.mcmadvisors.com/downloads/slaying\\_goliath.pdf](http://www.mcmadvisors.com/downloads/slaying_goliath.pdf)

It is frequently argued that one can always find cheap investments in an expensive market if one looks long and hard enough. I think that statement is true. But equities available at discounts to value, conservatively estimated, will tend to proliferate – perhaps even cascade – as the overall market becomes cheaper. Valuations below a Shiller PE of 10 are akin to thirsty value investors drinking from the proverbial fire hose. As the Shiller PE rises, bargains become increasingly rare, a (temporary) desert of value. An occasional oasis may be found, but undertaking the journey includes a higher probability of less favorable outcomes.

It's also a commonly held belief that broad diversification – among and within asset classes, globally, by investment vehicle, and so on – can mitigate losses because some will rise in value as others fall. At this point in our financial history, I fear that belief is dangerously flawed. As was revealed in 2008, when overleveraged markets begin to decline, the preference for liquidity becomes all-consuming, like the life-or-death struggle for a single life preserver thrown to non-swimmers when a boat capsizes. In an instant, all civility is suspended and everything is for sale at almost any price. Once uncorrelated assets begin to share a common fate – they sink together. Money to finance leveraged speculation is more plentiful and cheaper in 2014. If Emerson's Law of Compensation<sup>6</sup> holds true, 2008 may be remembered as having been the prelude rather than the coda.

The combination of free markets and behavioral psychology set the stage for one man's realized loss to be another man's prospective gain. It is more than mere coincidence that at the endpoint of a great carnage in which the vast majority of investors incur grievous losses, the purposeful and the patient, those who have the liquidity and the temperament to go against the grain of "conventional wisdom" (an oxymoron, to be sure), seize the low-risk opportunity born out of disillusionment and despair.

We humans are hardwired to avoid discomfort and pain. Thus the foolish reward the courtiers who tell them what they want to hear. The wise, on the other hand, bestow their gratitude on those who struggle, sometimes futilely, to reach them with the truth. This may not be what most people want to hear in a time of no safe havens, but, bluntly put, forgoing the above-mentioned \$20 today for what almost certainly will be better – quite probably much better – prices in the future may be the most commonsensical investment decision you'll have made in years, made all the more compelling as "what you pay" continues to rise at a faster clip than "what you get."

Frank Martin, CFA  
September 2014

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<sup>6</sup> Ralph Waldo Emerson's 1841 essay, *Compensation*, includes the following brief summary of his law: "Things refuse to be mismanaged long. *Res nolunt diu male administrari*. Though no checks to a new evil appear, the checks exist, and will appear."