

## **Distracted From Distraction By Distraction**

Fans at the recent baseball all-star game were given “beanie baby” stuffed animals upon entering the stadium. Dealers with fistfuls of \$100 bills were just inside the entry gates, buying the beanie babies from anyone willing to sell. U.S. customs regulations allow only one beanie baby per carload to enter the country, since the toys are more plentiful elsewhere. In interviews, collectors indicate that beanie babies will be the source of funds for their retirement and children’s college expenses. These stories, and tales of near-riots at fast food outlets giving away “teenie beanie babies,” started us thinking about what determines value.

***How much are those Franklin Mint “Dead Cowboys From Canada” medallions worth now?***

In the short run, value is whatever the market will bear, whether the object being valued is a beanie baby or a stick you pick up on the street. Even if something is deemed to be valuable now, however, it may not be similarly valued in the future. The higher the emotional content in the current valuation, the less stable the value is likely to be.

In the early 1970’s, one of the hot, speculative stocks was Franklin Mint. Franklin Mint sold medallions that commemorated a variety of topics. The medallions were considered valuable collector’s items, with projected fantastic future valuations for complete sets of the “coins.” Accordingly, many considered the coins an excellent investment. Of course, the “value” of the Franklin Mint medallions was ephemeral. We don’t have the heart to ask a collector we knew, who bragged about the coins as his retirement plan, how much his “Dead Cowboys From Canada” series is worth now. The medallions had no intrinsic value, just short-run emotional belief.

Emotion can be a powerful driver of prices in the stock market as well. After the recent run in the Internet stocks, America Online is valued approximately the same as ABC, CBS and NBC combined, while Yahoo is now worth more than the New York Times Co. We are big believers in the importance of technology, just like we were in the early 1980’s when there were more than 50 U.S. makers of computer hard drives and hundreds of PC manufacturers, the majority of which no longer exist.

Unlike “collectibles,” however, stocks and the market as a whole theoretically have an intrinsic value. Ultimately, the long-run worth of any stock is tied to the underlying business, as measured by earnings, dividends, book value or sales. In July 1996, our newsletter *Does Value Matter?* presented a study we did relating the value of the market, stated in terms of price relative to earnings, dividends and book value, to the subsequent performance of the market. The

study indicated that whether the stock market was cheap or expensive compared to historical valuations told you little about what would happen next year, but it was an excellent predictor of average returns over the next ten years.

The attached chart shows the results of a recent updating of our valuation study. You do better to buy the stock market when it is cheap than when it is expensive. In any human endeavor other than the stock market (buying tuna fish, for example) this would be non-controversial. It is controversial in the stock market now, however, because nobody, including us, wants the party to end.

While the stock market is now clearly expensive by fundamental measures, our study does not mean a disaster looms on the near horizon. The 10-year average performance after expensive markets is still positive, just disappointingly low compared to the long-run average return on stocks. Remember, however, that you don't get the 7 percent every year – it tends to be a mixture of some decent years with some pretty scary years. The odds that the 10-year total return after an expensive market will equal or exceed the long-term average return are less than one in eight.

***The stock market is a voting machine in the short run and a weighing machine in the long run***

A new generation of investors has never lived through a bear market lasting longer than a few days. Based upon limited personal experience, they prefer to believe we are in a new era where the old measures of value are outmoded. After all, the market has been “expensive” for the past three years, but the stock market has still gone up. This is consistent with our study, however – valuation is a long run indicator, but not a short run indicator. Bull markets develop momentum as outstanding returns encourage investors to put more money in the market, which in turn helps the market to continue upward – for awhile. By the way, this momentum works the other way too, as fear induces panic selling which leads to falling prices which produces more fear.

Just like with “collectibles,” though, the short run and long run determinants of value are different. Benjamin Graham, the father of fundamental stock market analysis, used to say that the stock market is a voting machine in the short run and a weighing machine in the long run. In other words, emotions, attitude and liquidity flows are key determinants of short run stock performance, but long run valuations tend to be based upon actual economic performance. And if your favorite Internet stock falls 90 percent in value, you can't even hug it like a beanie baby. If stuffed animals as an investment don't appeal to you and you want your portfolio to reflect weighing rather than voting, contact us.