

Who's Optimistic Today?

By Leo Abel, November 2011

It has been said, "A cynic knows the **price** of everything, but the **value** of nothing". Similarly, there is a wise adage which says that, "**Price** is what you pay, while **value** is what you get".

In the first part of this three part series entitled, "*Oh Honey, You Know Nothing Worthwhile Ever Comes Easy*", I talked about investment success that can occur as the result of faithfully executed investment strategies created for the realization of financial goals.

Investment performance juxtaposed with Investor results demonstrated the huge disparity between what investments do and what investors actually receive.

I referred to this behavioral friction as the, "Investor Behavior Penalty" and posed as its potential solution our **Six Pillar Money Management Process**.

As we explore the difference between price and value, it will become abundantly clear to readers that tremendous opportunities are available in the market today for those willing to take advantage of them.

What Is The Value of an Investment?

Let's begin with the **value** of an investment; in fact, any investment. What is it?

It is the discounted present value of the cash you will receive in the future. This is true whether investing in farm land, precious metals, nuclear power plants or businesses.

Assume that you own a piece of rental property which, net of expenses, generates \$50,000 per year in income. In 2006 this hypothetical piece of property may have garnered a **price** of \$1,000,000. Flashing forward to 2009 during the global credit crisis, let's assume that this property still generated \$50,000 in income after expenses. Under these assumptions, the **value** of the property would not have changed.

Price Is Another Issue

We know that at the peak of the crisis, a seller of this property would likely have been happy to have gotten a \$500,000 **price** for his property though the **value** would not have changed. Further, an investor in this property in 2006 would have been expected to receive a 5% return on his or her investment; while in 2009 the return would have risen to 10% based on the current **price** of \$500,000.

(This example is hypothetical and included illustrative purposes only. It doesn't reflect the performance of any investment.)

It was Ben Graham who stated it best about how the stock market values company shares in the marketplace.

He said:

“In the short run the stock market is a voting machine (heavily influenced by emotion), while in the long run it is a weighing machine (determined by fundamentals such as dividends, cash flows and earnings).”

So What Are We Seeing in Today’s Environment?

Economic and political problems persist, capturing all of the media’s attention. At the same time, businesses continue to execute despite it all. Raymond James Chief Investment Strategist, Jeff Saut, wrote on 10-31-2011:

“As of this morning, the 323 companies on the S&P 500 that have reported thus far have showed year-over-year earnings up 24.3% with revenues better by 12.8%”.

A core holding in most of our client portfolios is managed by Chris Davis who describes what they see with the businesses they own within the fund.

“Although the *prices* (Italics added by me) of many stocks we own have lagged for a number of years, the *values* (Italics added by me) of the businesses we own - as measured by sales, earnings, shareholder’s equity, dividends and so on - have continued to build.

“Although such a divergence can persist for long periods, as it has for the last five years, we do not believe it can persist forever”.

He further explains the geographic as well as product diversification of these companies and the fact that they grew their businesses during the worst economic downturn since the great depression.

He sums up with the following statement which succinctly completes the case I’ve been laying out for you.

“However, the economic characteristics of these companies are only half the reason we are so optimistic about future returns. The other half is valuation”.

Thousands of years ago a very wise man came up with the following expression,

“This too shall pass”.

When I think about this expression in the context of the investment environment today, I consider the following. The crises of today will at some point leave us only to be replaced by new future crises. What will also pass will be the opportunity to invest in the great businesses in the US and in the world at discounted ***prices*** which I believe are significantly below their actual ***values***.

Thanks for reading.

Sincerely,
Leo Abel, CFP®

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