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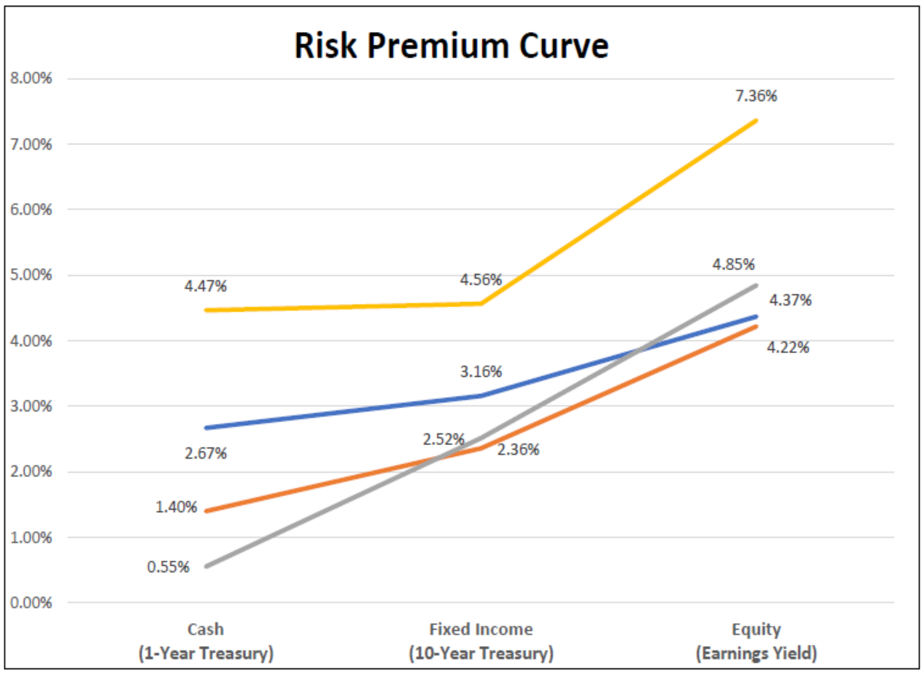
Mr. Market

Today I brushed off one my copies of the *Intelligent Investor* written by Ben Graham. It was his fifth edition from 1973, but the original was written in 1949. I've written many missives related to this topic, but please endure the repetition again as I do have a new chart I'll share at the end. In chapter 8, Graham gives a parable:

> *Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers to buy you out or sell you an additional interest on that basis. Sometimes his idea of value seems plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*
>
> *If you are a prudent investor or sensible businessman, will you let Mr. Market's daily communication determine your view of the value of your $1,000 interest in the enterprise? Only in the case you agree with him or want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when the price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position….*
>
> *The investor with a portfolio of sound stocks should expect their prices to fluctuate and should neither be concerned by sizable declines nor become excited by sizable advances. He should always remember that market quotations are there for his convenience, either to be taken advantage of or to be ignored. He should never buy a stock because it has gone up or sell a stock because it has gone down. He would not be far wrong if this motto read more simply: "Never buy a stock immediately after a substantial rise or sell one immediately after a substantial drop.*

We've witnessed some turbulence thus far in October. I won't try to explain why – that's Jim Cramer's job and other investment scorekeepers/counselors. Much time, energy, and resources are spent trying to explain the unexplainable (and unimportant). Corrections happen. They're normal and used to happen four times a year. We are under allocated to equities today compared to our target goal, not because we predicted this correction, but because prices are very high (by all our measures) and we like to own a lower allocation to equities when priced too dearly. The equity holdings we do own are a collection of great businesses that generate cash flow, pay dividends, buyback stock (especially when it's cheap), and are operated by owner-orientated management teams. Some of these businesses have dropped dramatically. This doesn't bother us and it shouldn't bother you. If Mr. Market offers a low enough price, we will add to our holdings in particular names. If not, as Graham says above, we will simply ignore his propositions.

In all our spare time ignoring Mr. Market, we did create a new diagram to better show the relationship between interest rates and equities. I've been using my arm to show the steepness of the yield for years – hopefully the diagram below is better. We call it the "Risk Premium Curve" and it's a combination of the yield curve (interest rates as measured by duration) and equity prices, as measured by earnings yield (inverse price-to-earnings). Simply, it shows the risk-free rate (one-year US Treasury yield) compared to the ten-year yield and the S&P 500 earnings yield (inverse P/E) over four periods. I think of equities as long duration assets that need to offer a spread to Treasurys given short-term volatility.



Legend	Color	Equity Risk Premium
Today		1.70%
1 Year Ago		2.82%
10 Year Average		4.29%
Long-Term Average		2.90%

Long-term Average: 1871 - Present

Sources: Robert Shiller Online Data & Multpl.com
S&P 500 Earnings Yield = Trailing 12 Month Earnings Divided by Index Price (Inverse PE)

The spread or advantage to own equities today is far below normal at 1.70% per annum, compared to the long-term and ten-year average of 2.90% and 4.29%, respectively. Maybe I have confirmation bias and want to create more models to agree with my thinking, but the Risk Premium Curve agrees with our other models: continue to under-weight equities. As (if) rates rise from here, equities will need to offer a more competitive return, which is transpiring as we speak.

Have a great weekend!

John

10/31/2018