Finding Fair Value

"In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

— Benjamin Graham
The Father of Value Investing

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WITH THE MINUTE-BY-MINUTE GYRATIONS of the DOW, S&P 500, 10-year U.S. Treasury, oil and so on, there is no shortage of breaking financial news to grab our attention. And as the headlines blare and the financial markets grow more volatile, individuals tend to forget what they are trying to accomplish as investors; they react emotionally as opposed to being calculated.

How do we calculate "price" in the financial markets? Take, for example, the S&P 500, a stock market index that tracks the stocks of 500 large-cap U.S. companies. To be in this group, a company must be in the United States and have an unadjusted market cap of at least $8.2 billion. At least half the corporation's stock must be available to the public at minimally a dollar per share. It must file a 10-K annual report. At least half its fixed assets and revenues must be in the United States. And it must have at least four consecutive quarters of positive earnings.

The S&P 500 tracks the market capitalization of the companies in its index. "Market cap," or company value, is the total value of all shares of stock outstanding to the public, calculated by multiplying the number of shares issued by the stock price, which is largely based on supply and demand. If the demand for a stock declines, we see the decline as there are r not enough buyers to support the previous price. As demand increases, the price rises as there is more interest in owning the stock.

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What drives the buying and selling — and the resulting movements in price — is expected company profits. For the S&P 500, it is the collective profits of those 500 companies that drive the index's price. Each company reports earnings on a quarterly basis and provides forward-looking guidance on what they expect their profit to be over the coming quarter and year. This gives investors a sense of clarity that the companies they own will continue to see growth, profitability and a rising stock price based on consistent demand. These factors are common in a normal economy, serve to increase demand for stocks and account for a stock's and index's "fair value."

In the current bear market, as in all bear markets, finding fair value is extremely difficult. The uncertainty over profits and a lack of corporate guidance lowers demand for stocks and consequently makes the financial markets volatile and potentially drives the S&P 500 index lower. Automated trading may exacerbate the lack of demand. It is difficult to fairly value a company or index when the collective profit level of 500 companies is potentially declining at an unknown rate. Investors will not know for certain what 2020 profits will be until the recession is over; in the interim, we experience wild speculation. Historical performance offers some peace of mind, as we have gone through periods of declining profits and uncertainty before, and profits have ultimately rebounded to move stock prices higher. In each event the stock markets have moved higher prior to profits rebounding, before the recession is complete. As such, the current index value does not reflect current corporate profits; it is an estimate of what potentially corporate profits will be.

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Speculating on profits in the near term causes market dislocation, making movement more emotional than calculated. As the economy recovers over the next three, six and 12 months, companies will begin to provide guidance and show consistency in their earnings. Long-term investing requires an understanding that profits will rise over time with periods of uncertainty along the way.

There is no question that we are in a period of uncertainty, of temporary profit decline. In such times, we often hear that "this time is different." We hear that each time. But profits will rebound as we get back to a normal economy. If investors can dismiss their emotions and be more calculated, they will see that profits do in fact rise over time and will return as we return to a normal economy. In the near term, the markets will try to find fair value, which can be a very tough task.

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