Can Value be Found in Volatility?

Market volatility is the value investors best friend. Without it buying shares at discounted prices could never happen. The value investor concept first developed by Columbia professors Benjamin Graham and David Dodd became very popular following Grahams 1949 book "The Intelligent Investor" and after all who would not want that title applied to themselves.

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The most famous follower of the principles put forward in the book includes Grahams one time student Warren Buffet regarded as the most successful investor ever.

Within the various theories on investing two major theories stand out in contrast to each other. Those who follow the Efficient Market theory and those who side with the Value Investing theory.

The former claim markets are so efficient that stock prices reflect all known information and therefore the current price of any stock is always correct at that moment and only new information can or should cause prices to rise or fall. The latter believe that outside factors sometimes cause stock prices to move away from their real value but that this is temporary. Therefore, buying them at a discount equals value as the stock will ultimately revert to its correct price delivering a return to the investor.

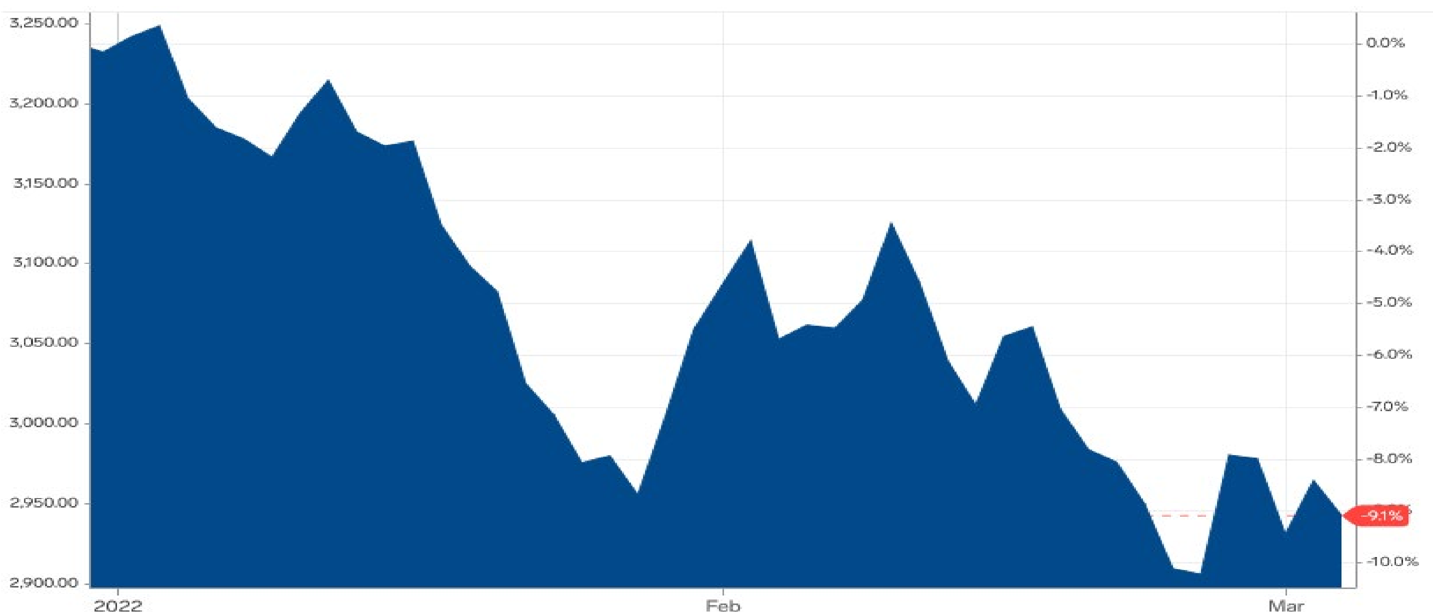
The MCSI World stock index is down 9.1% at the time of writing. January saw declines primarily linked to the American Federal Reserves faster than expected stance on raising interest rates this year to combat US inflation. February has seen a further decline linked to the Russian invasion of Ukraine.

So what does all this mean?

Well, if you are inclined to side with Graham and Buffet this volatility presents a chance to seek out some value investing opportunities. Therefore, keeping Buffet's famous quote "when others are greedy I'm fearful and when others are fearful I'm greedy" in mind, this is a time to buy. But finding value requires analysis and this challenge is not helped when faced with the multiple options that exist for establishing the correct share price of any company.

Do you use price to book value which measures the value of a company's assets and compares

MCSI All world index Jan 1st 2022 to Mar 03 2022



them to the stock price? In high-level terms if the price is lower than the value of the assets, the stock is undervalued assuming the company is not in financial hardship. Perhaps you use the Price/Earnings ratio which shows the company's track record for earnings to determine if the stock price is not reflecting all of the earnings or is undervalued. Others prefer Free Cash Flow to determine value, in other words the cash remaining after all operating expenses and capital expenditure have been paid. The money left over can be invested in the future of the business, pay off debt, pay dividends to shareholders or issue share buybacks.

Some or all of these methods sit at the heart of the value investor philosophy, volatility creates value and analysis reveals value. All in all, it seems like a job best left to expert fund managers.

However, if you side with the efficient market theory and everything is priced correctly now is a time to hold or maybe even sell depending on when you bought into the various markets. No one would ever like to crystallise a loss but there is no shame in taking a little less profit if this theory is right. The truth is perhaps somewhere in between, not all stocks are the same and not all companies have current valuations anywhere near the tried and tested methods of valuing stocks.

Companies whose valuations are based primarily on future earnings like many tech stocks will be more adversely affected by rising interest rates and inflation as the future value of those earnings is adjusted to reflect the decrease in real terms of their present-day value on the balance sheet. Time silently erodes the purchasing power of savings and earnings alike. Therefore, companies whose business models are all about future earnings potential and not so much about current earnings will be impacted more negatively by interest rate increases. Hence the disproportionate drop in tech stocks this year.

For those of you with monthly pension contributions, the current volatility should not be a concern. Monthly contributions benefit from a concept known as Euro Cost averaging which means that each month your cash contribution buys units in your selected funds. So, if the price of these funds falls you buy more units that month which over time has the impact of giving you an average price per unit bought smoothing out short-term volatility.

Anyone who is investing money whether it be through a pension fund, personally or with company funds should understand why markets react and sometimes overreact to events. The key to this is to understand what it means for your portfolio and how you can benefit from the active management of your funds during volatile markets.

Staying the Course

The instinct in volatile times is to move to safety, however, those who go into cash and bonds in these times will incur worse fund performance over the long term.

Looking at the chart below of the S&P 500 over 50 years you will see the impact of being out of the market in volatile times and missing the 'best days' which often come after the worst days.

What do you do?

Stay disciplined. Although it may be uncomfortable at times, staying the course and sticking to your strategic financial plan could better serve you in achieving your long-term financial goals.

- By missing just the best 10 days in the market from 2003 to 2017, your investment returns would have been 48% lower.
- Half of the top 10% days for market gains historically have happened in Bear Markets, so switching your funds after they fall could lead to you missing these upswings.
- Markets rise and fall daily, weekly, monthly – it is part of the natural cycle of investing. But historically, each significant market downturn has been followed by an eventual upswing.
- In the U.S., Monday March 23rd 2020 saw the third-best one-day gain for equities since 1945 for the S&P 500 after the two-day rebounds that followed the Black Monday Crash of 1987, and the Lehman Brothers bankruptcy in 2008.
- Despite the infamous 'Black Monday' of 1987, it was still a positive year for equities.
- Despite the last Bull Market being one of the longest on record, we still saw double-digit falls in 8 of the 11 years.
- Since 1980, European equities have finished the year in positive territory on 31 of 40 years, yet in each of those years, the market suffered an average intra-year decline of 15.2%.
- Keeping your money in cash is not the long-term answer as cash returns remain at record lows.
- Equities tend to recover strongly after large falls.
- Bear(falling) markets tend to be shorter than Bull Markets.

Diversify, Diversify, Diversify

A basic tenet of investing is diversification. This means spreading risk by mixing a range of asset classes within your portfolio. A well-diversified portfolio might include equities, bonds, alternatives, property, and cash and helps smooth the return over the long run. While there is no such thing as a 100% risk-free investment, diversification can mitigate the inherent risk of investing, helping you to reach your long-term financial goals.

As is so often true in life seek out those who are expert enough to advise you well. The harsh truth is that not all fund managers are created alike and yours may not be top tier. This is true with Irish pension fund managers. The difference between the best and worst in class is stark. It is always worth getting a review of your investment strategy especially when markets are volatile, who knows, value may just be lurking out there.