PARAGON CAPITAL MANAGEMENT, LLC

Greed, Fear . . . and Volatility

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Who can explain the stock market? If the media are to be believed, there are dozens of experts who can come on every day and tell us exactly why the market did what it did that day. Their explanations change often, usually focusing on the headlines of the day and trends, rather than on specific information and analysis.

We are going to try and explain the recent moves in the stock market by going back to some very basic definitions and long-proved truths. We apologize in advance if the information we present is too simple, but sometimes simple is best.

How do you value an investment? The intrinsic value of any investment is the present value of future cash flows. Valuing a bond is quite simple. Typically, a bond pays a constant coupon of interest for a set term of years, after which you receive your principal back in full. A 10-year bond, with a 3% coupon, purchased at par will return 3% per year over ten years. It is up to the investor to determine if that is an adequate return in exchange for the quality of the issuer and the term of the bond. Many variables affect the analysis of the bond (credit quality, taxability of interest payments received, size of coupon, is it priced at a discount or premium), but in the end the math remains the same.

What is a stock? It is not a piece of paper to be bought and then sold at a (hopefully) higher price. A share of stock represents ownership in a company; a small investment in every associate, plant, truck, store, website, product and service that the company uses or sells. More importantly, it represents a claim on company earnings, through dividends, an increased intrinsic value of the company, or an increased stock price.

How is a stock different? In a nutshell, there are more moving pieces in stock valuation. First, the coupon is not fixed, nor even defined. Is the coupon equivalent to the cash dividend (a portion of earnings), or Earnings per Share (EPS) regardless of dividend, or the increase/decrease in Book Value per Share? Second, at what rate will earnings/coupon grow over future years? What will happen during a recession, or expansion, or if a new competitor enters the industry? Third, how long will you hold the stock? Theoretically, a stock can be held forever. Finally, what rate of return do you think is acceptable over time? Nothing moves in a straight line forever; there are always ups and downs.

How do stock prices move? Even though investment theory is based on the notion that all investors are rational, they are not. Moreover, out of millions of investors with disparate ideas about valuation, every single one of them can "determine" the value of a multi-billion dollar company by what they are willing to pay for the stock in an open, public market. In essence, everyone is an expert.

Because everyone has different ideas about how to determine the assumptions that go into stock valuation, there are innumerable outcomes of what the true value of a stock is. However, in addition to quantitative analysis there is also qualitative analysis that takes place, sometimes subconsciously. This is the basis of behavioral finance.

When there is optimism about a company and its future growth prospects, the stock can become overvalued when investors give too much weight to immaterial news items. Conversely, negative news items and announcements can sometimes cause a stock to be undervalued although the news may be immaterial to the future prospects of a company.

Greed and Fear are emotions that come into play when a stock is mis-priced by a great degree. Typically, this is because investors have overestimated the positive or negative effect of a company announcement, industry shift, or news item. On the overvalued side, we currently see this in technology companies whose current revenues and earnings do not support a high Price/Earnings or Price/Cash Flow multiple, and whose mid-term prospects cannot grow quickly enough to achieve more reasonable valuations AND provide an adequate return on the investment.

To use a recent example, investors were so enamored with the FAANG stocks (Facebook, Amazon, Apple, Netflix, and Google) last year that positive news, regardless of how unimportant, was met with bridled optimism. Negative news was often dismissed with a shrug. Although these companies are fine companies with bright futures, their stock prices sometimes got ahead of valuations that would leave room for appreciation based on fundamentals. When an investor is tempted to buy a stock simply because they "don't want to miss out", that is the voice of greed, not reason.

On the other hand, sometimes stocks get pummeled on negative reports almost to the point that they are valued as though they are going out of business. These are the opportunities we look for; where companies can be bought for a bargain. Again, the size of the stock price move often outstrips the importance of the news due to fear of being left "holding the bag".

These environments are common and are most easily recognized in retrospect. However, one good indicator to be on the lookout for, to avoid euphoria or gloom, is to recognize a period of increased volatility in the stock market. The markets move every day, but the recent confluence of historically high market levels, historically low unemployment, low but rising interest rates, tax reform, potential trade wars, and upcoming elections makes the first half of 2018 a textbook case to study how outside influences affect the current business, and prospect, of industry leading companies.

The most common measure of stock market volatility is the CBOE VIX. You can see the marked increase in the following twelve-month chart:

The stock market is not an entity unto itself but is rather a collection of thousands of individual stocks and there are various measures of what the "market" is. However, whatever the composition of a stock market index is, be it market capitalization weighted or share price weighted, it is time to tread lightly when volatility increases. Because the market's volatility is a derivative of thousands of individual stocks' volatility, it can often be understated. An example of this is Facebook, which is down over 20% from its high due to *negative news which cannot rationally be quantified at this date.*

During times of increased volatility it is our practice, and our suggestion, to not make any rash investment decisions regarding stock purchases or sales, or changing how much of your portfolio you have allocated to equities. When stock prices are moving irrationally, the rational choices are to find long-term bargains and not to try and chase daily moves.

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Quarterly Reports
We have received positive feedback from our recent format changes. However, we understand that there is still some uncertainty regarding certain sections of the new report. We are always happy to sit down with you, or schedule a phone call, to explain the report in greater detail. If you think this would be helpful, please let us know.

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