Lumbard & Kellner INSIGHT

WHAT'S IT WORTH?

The value of an antique car is set by the highest bidder; a single person who is willing to pay way more than anybody else. You never know who will show up at the auction! Cars, boats, and Bitcoins are worth whatever a buyer is willing to pay.

This is also true of stock prices, but it's terribly misleading. If you believe that there's no fundamental value to stocks you'll start looking for magic in chart patterns or black boxes, and you'll worry that prices can go to zero. They say that rising stocks continue to rise, but wouldn't that suck up all the money in the world?

So let's start with bank CDs. You *know* what they're worth, because the FDIC guarantees that you'll get your money back; and the Fed's power to print money stands behind the FDIC. The only catch is that the interest rates on CDs are barely above the inflation rate. They're not a long-term plan for retirement savings. And the same can be said about gold, which should give you a return that's similar to the inflation rate because the metal is rare. Cryptocurrencies aren't rare, so the long-term returns should be much lower …

The government's power to print money also stands behind U.S Treasury bonds. Now we're getting somewhere, because bond yields are higher than CD rates, and higher than inflation. That "real" return is usually less than a percentage point, if you're buying 10-year treasury bonds. When interest rates are rising those bond returns drop below zero.

Bonds are debt; you lend money to the government or to a corporation. Shares of common stocks, on the other hand, represent *ownership* of a corporation, so the growth of your investment should be similar to the growth of the corporation. And corporations (all of them, together) grow about as fast as the economy.

Here's where we unveil the big secret. That growth isn't the 2% or 3% GDP growth that you read about in news reports, because that's an inflation-adjusted number. Corporate revenues, or sales, grow at the "nominal" GDP growth rate, which is twice as fast. It averaged 6.2% over the last 70 years.

Corporate earnings grow faster than corporate revenues, because they use part of their earnings to invest in growth initiatives that are meant to benefit the shareholders. Some of that is used to buy back shares; if they buy back half the shares, your piece of the company will be twice as big, so your earnings ***per share*** will double! That should cause the stock price to double.

You also have to add in your cash dividends, which grow every year. With moderate growth and inflation the theoretical return on common stocks is above 7%. The actual returns of the last few decades, with higher inflation and growth, and declining interest rates, exceeded 9% a year.

Of course, panic can send stock prices far below reasonable values. And euphoria, on some far future day, will push stocks to unsustainable heights. ■

PANIC

The stock market returns in much of American history have been so good that they're difficult to comprehend. The 45-year period from 1970 to 2015 included a financial crisis, the bursting of a stock-market bubble, and the bursting of two real-estate bubbles; but stocks still managed to multiply an investment 97 times. That is, if you invested $100,000 in 1970, 45 years later you had $9,700,000. **Half** of that, $4,850,000, came to you in 2011-2015, when your nest egg doubled for the last time.

No one expects stocks to travel in a straight line, but the market's wiggles nevertheless cause fear. 10% is called a "correction" and 20% is a "bear market", but neither one of these terms means that we're headed for a recession—or even a further decline in stock prices. Stocks can drop 11%, 15%, or 21% without providing any useful information about the future.

That's strange, because most of the time the stock market is a wonderful mechanism for predicting future earnings and interest rates, which are the only two things that matter in valuing stocks. Tens of thousands of investors each bring to the market an important insight or a valuable piece of information and toss it into the pot, from which rises a forecast of the future. Toss in a handful of fear, and you get nothing but demons and goblins.

It's not hard to get a decline started, because bad news is easy to come by, even in the best of times. Perhaps the latest economic statistics were a bit soft, or the last inflation report was higher than expected. Stocks have a bad day, a bad week, and then a bad month.

Stock-market pundits who have been calling for a decline suddenly feel vindicated, and TV programs give them air time to explain why they've always been right. 50,000 investors look at the still-falling indices, listen to the commentary, and sell part of their holdings; causing the market to fall further. This brings up memories of brutal market declines in past decades, and more people throw in the towel and sell. Hedge funds sell short, massively. A well-known bullish analyst changes his mind, causing his followers to sell. Technicians trumpet that the waves of selling are so powerful that support has been broken.

This is a self-sustaining dynamic, but eventually we reach the point where all the selling has been exhausted. Not all investors are willing to participate in this game. Corporate CEOs and other insiders buy shares, as do value investors who have cash available. Short sellers have to buy shares to take profits. Corporations buy their own stock, and fearless individuals make their annual IRA contributions and buy shares.

In 2016 the market bottom was established when one of our clients asked us to sell everything. Other investment advisers talk about the same phenomenon; one says that stocks never bottom until they have a "GMO"; a call from a client saying "Get Me Out". Don't be that guy!

Once the market starts rising, the same forces can propel it to unreasonable heights. "Reasonable" values can only be determined in hindsight, after we find out whether interest rates really did rise, or earnings really did decline. In the end, earnings and interest rates are all that matter.

The world is more connected than it's ever been, so fearfulness is easy to measure. If YOU feel afraid, the herd is afraid. And it won't be long before stock prices bottom. ■

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