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Irrational emotions put Wall Street in tizzy

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This year has been quite stressful for many investors, but often for the wrong reasons. To celebrate John Wiley & Sons' publication of West Coast Asset Management's "The Entrepreneurial Investor: The Art, Science and Business of Value Investing," we offer the following excerpts from Chapter 2. It explains that volatility is not necessarily evil and can, in fact, be the greatest generator of wealth.

At its best, the stock market democratizes capitalism, allowing individuals with limited capital to own shares of companies they wish to support. At its worst, the stock market is a gambling den, where speculators, raconteurs and outright con men play games with other people's money.

No matter how many rules of thumb one may apply to the stock market, the market still manages to behave in odd ways. For example, oil prices are still quite high and demand is challenging supply, yet many oil company stocks are trading at a fraction of their intrinsic value, even assuming 20 percent lower oil prices.

As a result, oil companies have been buying reserves on Wall Street for less than they would spend to discover them in the ground. This is illogical, but not entirely surprising.

When then-Federal Reserve Chairman Alan Greenspan made his famous 1996 remark about "irrational exuberance" escalating stock values beyond reason, he also spoke of the "unexpected and prolonged contractions" that follow (suggesting they weren't "unexpected" at all).

The stock market's rollercoaster history suggests that irrational exuberance works with a partner: irrational fear. Some say the stock market is like a wonderful cocktail party, except the last person to leave has to clean up. While at the party, everyone has a great time, but everyone also keeps an eye on the door. And when a few people start to leave, a mad rush follows, like lemmings rushing to the sea.



Fear and euphoria cause the market to overreact. For those who keep a cool head, opportunities abound.

In the 1997 blockbuster film "Men in Black," Detective James Edwards (Will Smith) says the "Men in Black" should reveal the truth about extraterrestrials living on Earth: "People are smart," he says. "They can handle it."

"A person is smart," replies Agent K (Tommy Lee Jones). "People are dumb, panicky, dangerous animals and you know it."

When emotions take over

Ten years before that film was released, Wall Street proved the point. On Oct. 19, 1987, the Dow Jones Industrial Average dropped more than 500 points, losing 22.6 percent of its value. This triggered panic selling in other exchanges worldwide. Yet within two years the market was back at pre-crash levels, suggesting that actual values were not completely out of line in 1987, but people's emotions were completely out of control.

A logical investor must take irrational market behavior into account when choosing stocks to buy, sell, and hold. Fear and euphoria cannot dominate the actions of someone who really knows the companies and industries in which he or she invests, but other people's fear and euphoria should influence one's choices.

Do not blindly follow the herd, but pay close attention to its movements. Opportunity exists in the gap between a company's value and the herd's perception of its value. Of course, it can take a long time for the herd to catch up, but that is how an entrepreneurial investor's patience is rewarded.

Long-term approach

Long-term thinking is essential because short-term volatility cannot be consistently predicted. But long-term trends allow greater perspective when choosing a stock because large-scale concepts like business cycles and "regression to the mean" improve our ability to evaluate probabilities. In other words, even though no one can predict the future, long-term trends have a higher probability of playing out.

The late Douglas Adams' hilarious book "The Hitchhiker's Guide to the Galaxy" notes that one reason the hitchhiker's guide is superior to the far more comprehensive "Encyclopedia Galactica" is the fact that the guide has etched into its cover two very important words: "Don't Panic." Excellent advice for a galactic sojourner and excellent advice for an intelligent investor.

Turning losses into gains

Because of mob dynamics, the stock market sometimes behaves irrationally. Individuals need not do so. Keep perspective. Prudent investors maintain a "watch list" of quality companies that should be considered when prices drop.

When the market dives, we know there are good companies available at bargain prices, and we act, providing the quality of the company has not changed. As long as we do our homework, know what we know and what we don't know, and stick to our long-term philosophy, we do not have to follow the bulls, bears or lemmings.



The price volatility of a company like Noven Pharmaceuticals (NOVN) allows an engaged investor multiple opportunities to buy and sell when it suits him best.

Entrepreneurial investors welcome volatility, and Benjamin Graham's famous "Mr. Market" metaphor explains why. Graham asks us to imagine that we are business partners with a slightly impaired gentleman named Mr. Market. He is a moody fellow. Every day, depending on how he feels, he knocks on our door and offers to buy our interest in the company or sell us his.

The prices offered by Mr. Market might be absurdly high or low, or they might be a fair value, based on our understanding of the business.

One of the nice things about Mr. Market is that he doesn't mind being ignored; he'll come right back tomorrow with another offer.

So we are in the driver's seat.

The point is this: If we know the actual value of the company, we need only buy or sell when the act benefits us. If we do not understand the value of the company, Mr. Market, foolish though he may be, holds sway over us.

Warren Buffett, citing Graham's parable, reminds us of the old poker axiom: "If you've been in the game thirty minutes and you don't know who the patsy is, you're the patsy." The story of Mr. Market warns us that the stock market exists to serve us, not to guide us.

— *Kinko's founder Paul Orfalea and Lance Helfert are co-founders of West Coast Asset Management in Ventura. Atticus Lowe and Dean Zatkowsky contributed to this column.*



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