

WHAT HAPPENS WHEN THE LUNATICS TAKE OVER THE ASYLUM?

If you think the stock market has lost its head, you are right! We are experiencing record volatility, which is a polite way of saying that the stock market is acting more like an amusement park ride than a financial asset. We have had more days of 4% plus daily moves in the past two months than we usually get in a decade. Only two times since the great depression has the market ever moved more than 4% four days in a row the way it did this summer, and it has never traded alternately up and down on those days the way it did in August. The VIX (fear-volatility index) that averages about 20 has been trading near 40 lately, reaching a high of 48 recently. This year's shenanigans come after last year's flash crash, where the market plunged and then recovered over 9% in the same day. Little wonder investors are throwing up their hands and saying, "Get me out of this mad house". The lunatics have taken over the asylum, and this is no place for a sane investor.

Domestic and International events have certainly helped fuel this volatility. It's not every year that sees the risk of a US default leading to a US debt downgrade, the near certain default by a member of the European Union, all in the backdrop of a slowing world economy and political deadlock.

But to explain the daily market swings, you have look to high frequency traders, massive use of derivatives, and computers that have taken the place of human logic. What may have been a bump in the road becomes a mountain by the time the day traders run the trend to the illogical extreme, and computer driven trading kicks in. It's all just speculative trading. It has nothing to do with where the underlying stocks are cheap or expensive, what earnings will be, or how bright a company's prospects are.

You might think this is a disaster for long term investors, but Warren Buffet, the man who has made more money investing in equities than anyone else in history, says quite the opposite. He says market madness is a rational investor's best friend. Here is my version of the story he likes to tell.

Let's say there is no stock market. You own stocks, but the only person you can buy and sell them from is a man named Mr. Market. Mr. Market is a lovely man. Every day he comes to work and posts a price at which he is willing to buy or sell your securities. The only problem is that Mr. Market is a manic depressive. Most of the time medications keep the disease in check, but often he comes to work in a deep melancholy thinking the world is coming to an end and posts prices for your securities that are far below what they are worth. At other times, in a fit of manic hysteria, Mr. Market will pay you much more for your stock than he normally would (would if he was normal).

If this sounds familiar, it's because it's what happens when the lunatics take over the markets. No one complains when the market values stocks at ludicrously high prices, but when the market goes into a dive, it is always because it is insane. Buffett told this story a long time before the recent market volatility, which just goes to show that the stock market has always been fickle if not downright psychotic. The question is; are investors better off or not, in a market that has lost its sanity? If you listen to Mr. Market you will certainly be worse off. He'll have you selling stocks at half of what they were selling for a few days ago and buying them back a short time later at much higher prices. He'll have you higher than a kite on every piece of minor good news, and in a state of deep depression on every minor setback. But, if you trade against Mr. Market, you will be much better off than if he was sane. True, you will lose some

liquidity. There will be times when you do not want to buy from Mr. Market, and certainly times when you do not want to sell, but that's a small price to pay for the ability to buy stocks at a steep discount to what you could get if Mr. Market was rational. And yes, sometimes there will be chances to sell equities at ridiculously high prices. Looked at it that way, the crazier Mr. Market gets, the more money you should make!

In the real world, Mr. Market is the result of millions of market participants with quite different, if not diametrically opposed objectives. The program traders love the volatility and quick reversals, the day traders want a short term trend, quantitative traders want a longer term trend, and long-term investors would prefer some stability. What should an investor make of the new volatility, the flash crash, a market that dropped 50% in less than four months during the last market crash and nearly regained it all in the next two years? Certainly the message isn't that the market is rational. No the market is a marvelous tool of overreaction.

But the question is still, can an investor use this irrationality to their advantage. I think they can. As value investors we are not shocked that there are times when individual stocks, industries, or the whole market are mispriced. It's how we make our living. The more irrational the market becomes, the more opportunity we have to beat it.

If you measure your investment returns in years instead of seconds. If you are willing to accept the fact that when the market is too cheap, you just have to hold onto your stocks instead of accepting much less than they are worth. If you are willing to ignore the crowd when they tell you that today's hot stock is going to the moon. **If you are able to keep your head when everyone around you is losing theirs...market volatility is your friend.**

Look at it this way. You are playing poker. Who would you rather have across the table from you; a calculating genius or a mad man? I am always amazed by investors who with one breath say the market is crazy and in the next breath say to sell all their stocks because the market is down. Why would you follow the advice of a mad man?

Instead, here is our plan. When the market moves up and down violently, we ignore it like we would a child having a temper tantrum. We don't have time to deal with it. But when the tantrums turn into major market moves, we try to capitalize on it by buying low and selling high. It sounds simple, but it's the exact opposite of what most people do.

Selling when stocks are high doesn't mean going to cash, it means selling high priced stocks and buying stocks or market sectors that are cheaper. Similarly, we can take advantage of market corrections even if we are fully invested by rebalancing stock and bond portfolios and selling more conservative, slower growing companies to buy the best and brightest that were too expensive to own before the correction started.

Our best period of relative market performance occurred during the 2000-01 tech bubble when we were underweighted in technology going into the bubble and able to buy tech and growth stocks during the crash. That allowed us to outperform when the market recovered. Today many technology and financial stocks are priced at or below the valuations they saw in 2002.

We are as unsure as to when the market will turn around as we were then. Nobody can accurately predict when market cycles reverse. If we are obsessed with the timing of these events, it will only divert our attention from what we know. What we know is that the market is overcome by fear. Stocks are cheap. Owning stocks at these levels has been highly profitable for investors willing to ignore the lunatics. **Bill Matthes**