Buffett, Klarman and Graham on the Parable of *Mr. Market*

These investors will describe the mental attitude that an investor should take towards prices.

<u>Berkshire Hathaway 1987: Marketable Securities - Permanent Holdings</u>

Whenever Charlie and I buy common stocks for *Berkshire's* insurance companies we approach the transaction as if we were buying into a private business. We look at the economic prospects of the business, the people in charge of running it, and the price we must pay. We do not have in mind any time or price for sale. Indeed, we are willing to hold a stock indefinitely so long as we expect the business to increase in intrinsic value at a satisfactory rate. When investing, we view ourselves as business analysts - not as market analysts, not as macroeconomic analysts, and not even as security analysts.

Our approach makes an active trading market useful, since it periodically presents us with mouth-watering opportunities. But by no means is it essential: a prolonged suspension of trading in the securities we hold would not bother us any more than does the lack of daily quotations on *World Book* or *Fechheimer*. Eventually, our economic fate will be determined by the economic fate of the business we own, whether our ownership is partial or total.

Ben Graham, my friend and teacher, long ago described the <u>mental attitude</u> toward market fluctuations that I believe to be most conducive to investment success.[1] He said that you should imagine market quotations as coming from a remarkably accommodating fellow named *Mr. Market* who is your partner in a private business. Without fail, *Mr. Market* appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, *Mr. Market*'s quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: ***Mr. Market* is there to serve you, not to guide you.** It is his pocketbook, not his wisdom that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business

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[1] See Graham's writings on "*Mr. Market*" on pages 2 and 3.

far better than *Mr. Market*; you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, *you're* the patsy."

Ben's *Mr. Market* allegory may seem out-of-date in today's investment world, in which most professionals and academicians talk of efficient markets, dynamic hedging and betas. Their interest in such matters is understandable, since techniques shrouded in mystery clearly have value to the purveyor of investment advice. After all, what witch doctor has ever achieved fame and fortune by simply advising "Take two aspirins"?

The value of market esoterica to the consumer of investment advice is a different story. In my opinion, investment success will not be produced by arcane formulae, computer programs or signals flashed by the price behavior of stocks and markets. **Rather an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super-contagious emotions that swirl about the marketplace.** In my own efforts to stay insulated, I have found it highly useful to keep Ben's *Mr. Market* concept firmly in mind.

Following *Ben's* teachings, *Charlie* and I let our marketable equities tell us by their operating results - not by their daily, or even yearly, price quotations - whether our investments are successful. The market may ignore business success for a while, but eventually will confirm it. **As Ben said: "In the short run, the market is a voting machine but in the long run it is a weighing machine."** The speed at which a business's success is recognized, furthermore, is not that important as long as the company's intrinsic value is increasing at a satisfactory rate. In fact, delayed recognition can be an advantage: It may give us the chance to buy more of a good thing at a bargain price.

Sometimes, of course, the market may judge a business to be more valuable than the underlying facts would indicate it is. In such a case, we will sell our holdings. Sometimes, also, we will sell a security that is fairly valued or even undervalued because we require funds for a still more undervalued investment or one we believe we understand better.

We need to emphasize, however, that we do not sell holdings just because they have appreciated or because we have held them for a long time. (Of Wall Street maxims the most foolish may be "You can't go broke taking a profit.") We are quite content to hold any security indefinitely, so long as the prospective return on equity capital of the underlying business is satisfactory, management is competent and honest, and the market does not overvalue the business.

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Seth Klarman mentioning *Mr. Market* in Margin of Safety

Foreword

When I was a boy I spent some time in a ranch in Montana. On Saturday nights we would drive into town to a cozy tavern where there was a perpetual poker game. This arrangement provided the house with two advantages from which it profited mightily. First, it sold whiskey to the players, and second, it furnished a permanent dealer—a girl, as it happened—who didn't

drink herself. The cowboys' mission was to have a good time after a tough week. Hers was to make money for her employer. She knew the odds, *(she was rational)* and almost always pulled further and further ahead as the night wore on and the cowboys, lubricated by booze, became ever jollier and more prone to exciting but illogical bets (emotional investors, the Cowboys were *Mr. Market*, *Ben Graham*'s term for the emotional swings in the market).

In all games the difference between the amateur and the professional is that the professional plays the odds, while the amateur, whether he realizes it or not, is among other things a thrill seeker. Investment, too, is part science and part a game, and just as in poker, **you need to sort out your motives.** The essence of the whole matter is buying a company in the market for less than its appraised value. Fortunately, most of the other investment players are quite emotional, so if you are thorough and patient, you can find good deals. However, they will rarely be easy, since many other people are looking for the same thing. Thus, to prosper in the investment game, as in any other, requires that you be right—so you'll win—and different—so you'll get attractive odds. I hope that this book will help you do that.

Taking Advantage of Mr. Market

Financial-market participants must choose between investment and speculation. Those who (wisely) choose investment are faced with another choice, this time between two opposing views of the financial markets. One view, widely held among academics and increasingly among institutional investors, is that the financial markets are efficient and that trying to outperform the averages is futile. Matching the market return is the best you can hope for. Those who attempt to outperform the market will incur high transaction cost and taxes, causing them to under perform instead.

The other view is that some securities are inefficiently priced, creating opportunities for investors to profit with low risk. This view was perhaps best expressed by *Benjamin Graham*, who posited the existence of a *Mr. Market*, an ever helpful fellow, *Mr. Market* stands ready every business day to buy or sell a vast array of securities in virtually limitless quantities at prices that he sets. He provides this valuable service free of charge. Sometimes *Mr. Market* sets prices at levels where you would neither want to buy or to sell. Frequently, however, he becomes irrational. Sometime he is optimistic and will pay for more than securities are worth. Other times he is pessimistic, offering to sell securities for considerable less than underlying value. Value investors—who buy at a discount from underlying value—are in a position to take advantage of *Mr. Market* irrationality.

Some investors—really speculators—mistakenly look to *Mr. Market* for investment or for investment guidance. They observe him setting a lower price for a security and, unmindful of his irrationality, rush to sell their *Holdings*, ignoring their own assessment of underlying value. Other times they see him raising prices and, trusting his lead, buy in at the higher figure as if he knew more than they. The reality is that *Mr. Market* knows nothing, being the product of the collective action of thousands of buyers and sellers who themselves are not always motivated by investment fundamentals. Emotional investors and speculators inevitably lose money; investors who take advantage of *Mr. Market's* periodic irrationality, by contrast, have a good chance of enjoying long-term success.

Mr. Market's daily fluctuations may seem to provide feedback for investors' recent decisions. For a recent purchase decision rising prices provide a positive reinforcement; falling prices, negative reinforcement. If you buy a stock that subsequently rises in price, it is easy to allow the positive feedback provided by *Mr. Market* to influence your judgment. You may start to believe that the security is worth more than you previously thought and refrain from selling, effectively placing the judgment of *Mr. Market* above your own. You may even decide to buy more shares of this stock, anticipating *Mr. Market's* future movements. As long as the price appears to be rising, you may choose to hold, perhaps even ignoring deteriorating business fundamentals or a diminution in underlying value.

Similarly, when the price of a stock declines after its initial purchase, most investors, somewhat naturally, become concerned. They start to worry that *Mr. Market* may know more than they do or that their original assessment was in error. It is easy to panic and sell at just the wrong time. Yet if the security truly a bargain when it was purchased, the rational course of action would be to take advantage of this even better bargain and buy more. *Louis Lowenstein* has warned us not to confuse the real success of an investment with its mirror of success in the stock market. The fact that a stock rises does not ensure that the underlying business is doing well or that the price increase is justified by a corresponding increase in underlying value. Likewise, a price fall in and of itself does not necessarily reflect adverse business developments or value deterioration[2].

It is vitally important for investors to distinguish stock price fluctuations from underlying business reality. If the general tendency is for buying to beget more buying and selling to precipitate more selling, investors must fight the tendency to capitulate to market forces. You cannot ignore the market—ignoring a source of investment opportunities would obviously be a mistake—but **you must think for yourself** and not allow the market to direct you. Value in relation to price, not price alone, must determine your investment decisions. If you look to *Mr. Market* as a creator of investment opportunities (where price departs from underlying value), you have the makings of a value investor. If you insist on looking to *Mr. Market* for investment guidance, however, you are probably best advised to hire someone else to manage your money.

Security prices move up and down for two basic reasons: to reflect business reality (or investor perceptions of that reality) or to reflect short term variations in supply and demand. Reality can change in a number of ways, some company-specific, others macroeconomic in nature. If *Coca-Cola* business expands or prospects improve and the stock price increases proportionally, the rise may simply reflect an increase in business value. If *Aetna's* share price plunges when a hurricane causes billions of dollars in catastrophic losses, a decline in total market value approximately equal to the estimated losses may be appropriate. When the shares of *Fund American Companies, Inc.* surge as a result of the unexpected announcement of the sale of its major subsidiary, *Fireman's Fund Insurance Company*, at a very high price, the price increase reflects the sudden and nearly complete realization of underlying value. On a macroeconomic level a broad-based decline in interest rates, a drop in corporate tax rates, or a rise in the expected rate of economic growth could each precipitate a general increase in security prices.

Security prices sometimes fluctuate not based on any apparent changes in reality, but on changes in investor perception. The shares of many biotechnology companies doubled and tripled in the first months of 1991, for example despite a lack of change in company or industry fundamentals that could possibly have explained that magnitude of increase. The only explanation for the price rise was that investors were suddenly willing to pay much more than before to buy the same thing.

In the short run supply and demand alone determine market prices. If there are many large sellers and few buyers, prices fall, sometimes beyond reason. Supply-and-Demand imbalances can result from year-end tax selling, an institutional stampede out of a stock that just reported disappointing earnings, or an unpleasant rumor. Most day-to-day market prices fluctuations result from supply-and-demand variations rather than from fundamental developments.

Investors will frequently not know why security prices fluctuate. They may change because of, in the absence of, or in complete indifference to changes in underlying value. In the short run investor perception may be as important as reality itself in determining security prices. It is never clear which future events are anticipated by investors and thus already reflected in today's security prices. Because security prices can change for any number of reasons and because it is impossible to know what expectations are reflected in any given price level, investors must look beyond security prices to underlying business value, always comparing the two as part of the investment process.

Unsuccessful Investors and Their Costly Emotions

Unsuccessful Investors are dominated by emotion. Rather than responding coolly and rationally to market fluctuations, they respond emotionally with greed and fear. We all know people who act responsibly and deliberately most of the time but go berserk when investing money. It may take them many months, even years, of hard work and disciplined saving to accumulate the money buy only a few minutes to invest it. The same people would read several consumer publications and visit numerous stores before purchasing a stereo or camera yet spend little or no time investigating the stock they just heard about from a friend. Rationality that is applied to the purchase of electronic or photographic equipment is absent when it comes to investing.[3]

Many unsuccessful investors regard the stock market as a way to make money without working rather than as a way to invest capital in order to earn a decent return. Anyone would enjoy a quick and easy profit, and the prospect of an effortless gain incites greed in investors. Greed leads many investors to seek shortcuts to investment success. Rather than allowing returns to compound over time, they attempt to turn quick profits by acting on hot tips. They do not stop to consider how the tipster could possibly be in possession of valuable information that is not illegally obtained or why, if it is so valuable, it is being made available to them.[4] Greed also manifests itself as undue optimism or, more subtly, as complacency in the face of bad news.

[3] Read Ayn Rand's books, Atlas Shrugged and The Fountainhead which provide a philosophical underpinning to the belief that man's greatest attainments are due to his reason and rationality.
[4] An intelligent investor will always ask who is on the other side of the trade from him or her and why do I have this opportunity?

Finally greed can cause investors to shift their focus away from the achievement of long-term investment goals in favor of short-term speculation.

High levels of greed sometimes cause new-era thinking to be introduced by market participants to justify buying or holding overvalued securities. Reasons are given as to why this time is different from anything that came before. As the truth is stretched, investor behavior is carried to an extreme. Conservative assumptions are revisited and revised in order to justify ever higher prices, and a mania can ensue. In the short run resisting the mania is not only psychologically but financially difficult as the participants make a lot of money, at least on paper. Then, predictably, the mania reaches a peak, is recognized for what it is, reverses course, and turns into a selling panic. Greed gives way to fear, and investor losses can be enormous.

As I discuss later in detail, junk bonds were definitely such a mania. Prior to the 1980s the entire junk bond market consisted of only a few billion dollars of "fallen" angels." Although newly issued junk bonds were a 1980s invention and were thus untested over a full economic cycle, they became widely accepted as a financial innovation of great importance, with total issuance exceeding $200 billion. Buyers greedily departed from historical standards of business valuation and creditworthiness. Even after the bubble burst, many proponents stubbornly clung to the validity of the concept.

The Relevance of Temporary Price Fluctuations

In addition to the probability of permanent loss attached to an investment, there is also the possibility of interim price fluctuations that are unrelated to underlying value. (Beta fails to distinguish between the two.) Many investors consider price fluctuations to be a significant risk: if the price goes down, the investment is seen as risky regardless of the fundamentals. But are temporary price fluctuations really a risk? Not in the way that permanent value impairments are and then only for certain investors in specific situations.

It is, of course, not always easy for investors to distinguish temporary price volatility, related to the short-term, forces of supply and demand, from price movements related to business fundamentals. The reality may only become apparent after the fact, while investors should obviously try to avoid overpaying for investments or buying into businesses that subsequently decline in value due to deteriorating results, it is not possible to avoid random short-term market volatility. Indeed, investors should expect prices to fluctuate and should not invest in securities if they cannot tolerate some volatility.

If you are buying sound value at a discount, do short-term price fluctuations matter? In the long-run they do not matter much; value will ultimately be reflected in the price of a security. Indeed, ironically, the long-term investment implication of price fluctuations is in the opposite direction from the near-term market impact. For example. Short-term price declines actually enhance the returns of long-term investors.[5] There are, however, several eventualities in which

[5] Consider the example of a five-year 10 percent bond paying interest semiannually which is purchased at par ($100). Assuming that interest rates remain unchanged over the life of the bond, interest coupons can also be invested at 10 percent, resulting in an annual rate of return of 10 percent for that bond. If immediately after the bond is purchased, interest rates decline to 5 percent, the bond will initially rise to $121.88 from $100. The bond rises in price to reflect the present value of 10 percent interest coupons discounted at a 5 percent interest rate over five years. The bond could be sold for a profit of nearly 22 percent. However, if the investor decides to hold the bond to maturity, the annualized return will

near-term price fluctuations do matter to investors. Security holders who need to sell in a hurry are at the mercy of market prices. The trick of successful investors is to sell when they want to, not when they have to. Investors who may need to sell should not own marketable securities other than U.S. treasury bills.

Near-term security prices also matter to investors in a troubled company. If a business must raise additional capital in the near term to survive, investors in its securities may have their fate determined, at least in part, by the prevailing market price of the company's stock and bonds.

The third reason long-term oriented investors are interested in short-term price fluctuation is that *Mr. Market* can create very attractive opportunities to buy and sell. If you hold cash, you are able to take advantage of such opportunities. If you are fully invested when the market declines, your portfolio will likely drop in value, depriving you of the benefits arising from the opportunity to buy in at lower levels. This creates an opportunity cost, the necessity to forego future opportunities that arise. If what you hold is illiquid or unmarketable, the opportunity cost increases further; the illiquidity precludes your switching to better bargains.
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The Intelligent Investor by Benjamin Graham, Rev. Ed. Pages 204-206

Let us close this section with something in the nature of a parable. Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named *Mr. Market*, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects are you know them Often, on the other hand, *Mr. Market* lets his enthusiasm or his fears run away with him, and the value he proposed seems to you a little short of silly.

If you are a prudent investor or a sensible businessman, will you let *Mr. Market's* daily communication determine your view of the value of a $1,000 interest in the enterprise? Only in case you agree with him or in the case you want to trade with him. You may be happy to sell out to him when he quotes you a ridiculously high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position.

The true investor is in that very position when he owns a listed common stock. He can take advantage of the daily market price or leave it alone, as dictated by his own judgment and inclination. He must take cognizance of important price movements, for otherwise his judgment will have nothing to work on. Conceivably they may give him a warning signal which he will do well to heed—this in plain English means that he is to sell his shares *because* the price has gone

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be only 9.10 percent. This is less than in the flat interest case because the interest coupons are reinvested at five percent, not 10 percent. Despite the potential short-term profit from a decline in interest rates, the return to the investor who holds on to the bonds is actually reduced.

Similarly, if interest rates rise to 15 percent immediately after purchase, the investor is faced with a market decline from par to $82.84, a 17 percent loss. The total return, if he holds the bond for five years, is increased, however, to 10.99 percent as coupons are reinvested at 15%. This example demonstrates how the short-term and long-term perspectives on an investment can diverge. In a rising market, many people feel wealthy due to unrealized capital gains, but they are likely to be worse off over the long run than if security prices had remained lower and the returns to incremental investment higher.

down, foreboding worse things to come. In our view such signals are misleading at least as often as they are helpful. Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies.

The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are important to him in a practical sense, because they alternately create low price levels at which he would be wise to buy and high price levels at which he certainly should refrain from buying and probably would be wise to sell.
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Commentary by Jason Zweig on Graham's *Mr. Market*

The happiness of those who want to be popular depends on others; the happiness of those who seek pleasure fluctuates with moods outside their control; but the happiness of the wise grows out of their own free acts—Marcus Aurelius

Most of the time, the market is mostly accurate in pricing most stocks. Millions of buyers and sellers haggling over price do a remarkably good job of valuing companies—on average. But sometimes, the price is not right; occasionally, it is very wrong indeed. And at such times, you need to understand *Graham's* image of *Mr. Market*, probably the most brilliant metaphor ever created for explaining how stocks can become mispriced. The manic-depressive *Mr. Market* does not always price stocks the way an appraiser or a private buyer would value a business. Instead, when stocks are going up, he happily pays more than their objective value; and, when they are going down, he is desperate to dump them for less than their true worth.

The intelligent investor shouldn't ignore *Mr. Market* entirely. Instead, you should do business with him—but only to the extent that it serves your interests. *Mr. Market's* job is to provide you with prices; your job is to decide whether it is to your advantage to act on them. You do not have to trade with him just because he constantly begs you to.

One of *Graham's* most powerful insights is this: "The investor who permits himself to be stampeded or unduly worried by unjustified market decline in his holdings is perversely transforming his basic advantage into a basic disadvantage."

What does *Graham* mean by those words, "basic advantage"? He means that the intelligent individual investor has the full freedom to choose whether or not to follow Mr. Market. You have the luxury of being able to think for yourself.[6]

[6] When asked what keeps most individual investors from succeeding, Graham had a concise answer: "The primary cause of failure is that they pay too much attention to what the stock market is doing currently." See "Benjamin Graham: Thoughts on Security Analysis", Financial History magazine, no. 42, March 1991, page 8

Recognize that investing intelligently is about controlling the controllable. You can’t control whether the stocks you buy will outperform the market today, next week, this month, or this year; in the short run, your returns will always be hostage to *Mr. Market* and his whims. But you *can* control:

- your own behavior, by avoiding constantly watching your portfolio, listening to CNBC and market prognosticators and other “experts.”

- your expectations, by using realism, not hope to forecast your returns.

- your risk, by deciding how much of your total assets to put at hazard in the stock market, by diversifying, and by rebalancing.

Just remember that investing really isn’t about beating others at their game. It is about controlling yourself at your own game.

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