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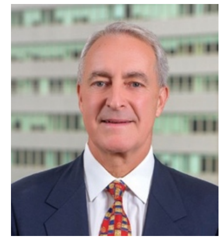

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Thoughts for Investors

Why Do Stocks Go Up?

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"The object of a New Year is not that we should have a new year. It is that we should have a new soul."
– G.K. Chesterton

There are two simple reasons why stocks go up and in this issue of Thoughts for Investors I will tell you those reasons. You may ask, if it is that easy to identify why stocks go up then why do investors have such a difficult time. I'll address that question as well.

Reason #1 – Earnings

Companies survive and thrive because they eventually earn money. After paying their bills (such as raw materials, labor costs, rent, etc.), companies retain some earnings and compound them by reinvesting in the company. Hopefully, this helps them earn even more money. When rising earnings are divided among each common stock share (known as "earnings per share" or "eps") the stock usually goes up. Additionally, it is good if there are not too many shares outstanding among which the earnings have to be "shared."

Sometimes a company's share price rises in concert with the announcement of increased earnings. More often, share prices rise before higher earnings are announced, serving to confuse investors. Even more confounding is when a stock's price falls after great earnings are announced. This usually happens because there won't be any more earnings news until the next quarterly report and there is skepticism that rate of earnings growth will be repeated.

Volatile earnings (due to many factors including economic cycles, competition and management's actions) usually increase the volatility of the stock price. The payment of a dividend is one way a company can reward patient investors for putting up with volatility. Finding a stock that consistently increases its earnings is more difficult than it seems. That's why investors who find and buy such a stock should be prepared to hang on through the inevitable volatility.

"Not everything that counts can be counted, and not everything that can be counted counts"
– Albert Einstein

Reason #2 – Assets

Sometimes it is worthwhile investing in the stock of a company even if it doesn't have much earnings growth. This occurs when the company owns assets that you believe are undervalued.

Decades ago, the assets of many companies consisted of "plant and equipment." Successful investors calculated (often by hand) how undervalued the assets were and, more importantly, whether there was a chance that the value might someday be recognized and reflected in the stock's price. With the internet, that information is calculated for you, accessible to virtually everyone, and thus dilutes its effectiveness.

Unfortunately, many of the assets of today's companies are harder to value as they are not "physical." The value of patents, happy repeat customers or key employees is harder to quantify. "Fabless" semiconductor companies don't own their own plants, choosing to subcontract manufacturing to someone else. How does one quantify the "value" of freeing a company from manufacturing hassles versus the lack of control over such an important task? As a result, finding a stock whose price should rise because its assets are undervalued is increasingly difficult.

In summary, there are two reasons stocks go up: companies make, increase and compound earnings per share, or companies possess undervalued assets whose value is ultimately realized. But if "why stocks go up" can be reduced to two simple reasons, why is investing so difficult? There is actually a third reason that explains why.

"Between the optimist and the pessimist, the difference is droll. The optimist sees the doughnut; the pessimist the hole."

– Oscar Wilde

Reason #3 – Emotions

Emotion is as much, if not more, the cause of a rising stock price as rising earnings or undervalued assets. Let me explain. If you found a paint-splattered canvas and learned it was done by your five-year-old son, you would hang it in your office. But if you found out it was done by the artist Jackson Pollock, you would hang it in your home or sell it. Why? Because you believe it is worth more, or perhaps more to the point, you believe someone else may believe it is worth more. In other words, emotion is dictating its value. Likewise with stocks. The prices of many stocks are higher today than one year ago even though earnings are not near their old peak of years ago. It's simply that investors are less pessimistic (on the whole) than they were one year ago and are willing to pay more for a given level of earnings. The "professional" term for investors' willingness to pay higher stock prices for increasingly optimistic future earnings estimates is "PE expansion." As the great investor John Templeton pointed out, "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." Notice Templeton never says anything about "earnings" or "assets." He simply describes the effect that emotion has on prices. The price of gold today is an example of the role of emotion. By far the biggest use of gold is for jewelry. Yet can anyone say gold's meteoric rise is explained by an equally meteoric rise in the demand for jewelry?

So there are actually three reasons why stocks go up. Of course stocks can go down for the opposite of those three reasons – little or no earnings, overvalued assets, or bleak investor emotion. Dealing with the impact of emotion is what, in my opinion, is the most difficult aspect of investing.

"Above all else, the stock market is people.

– Bernard Baruch

Some people believe they can avoid dealing with the effect of emotion when investing. While there are formulae that can calculate earnings potential or asset values, there is no formula for emotion. Besides, even formulae for the former cease to be effective as they become widely accepted and used. The creation and use of formulae for "asset allocation" models and exchange traded funds, and the myriad of ratios (up market and down market performance, alphas, betas, back-testing, Monte-Carlo simulation, attribution analysis, r-squared, Sharpe ratios, etc.) are attempts to calculate one's way to success. In my opinion, it's driving by looking out the rear window; all these calculations are done in hindsight and none can tell you what stocks to choose for a portfolio.

So now you know the three reasons stocks go up, including the outsized effect of emotion. Hopefully you can appreciate the importance of controlling your emotion and the value of capitalizing on others lack of emotional control. So how does one find the stocks that have growing earnings or undervalued assets or out-of-whack emotions? As Warren Buffett says, "Start with the A's."

"No man fully capable of his own language ever masters another."

– George Bernard Shaw

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