THE INVERSE RELATIONSHIP BETWEEN PRICE AND VALUE

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"Price is what you pay. Value is what you get." - Warren Buffett

Almost every *truly* successful investor I've ever heard of – *those whose success has stood the test of time* –advocates value investing; with Warren Buffett being the most successful of all. Regardless of the specific investing approach, underpinning all investment endeavors is the aspiration to "buy low" and "sell high". However, in order to know what is "low" and "high", we must have a good idea as to what the underlying business is actually worth.

Determining the underlying, or 'intrinsic', value of the business, and then only investing when you can do so well below that underlying value (i.e. with a margin of safety), are core principles of value investing. This is where the notion of buying a dollar for eighty cents comes in. Expressed another way, successful investors only invest in a company when it offers adequate *value* in relation to the current market price. This leads us to the *inverse* relationship between price and value. . .

"The investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage." - Benjamin Graham

When the share price goes down, *value* goes UP, and vice-a-versa. Given this information, when faced with short term market volatility the reaction of most investors is completely irrational. For many investors, when the price of a given investment goes down, and the underlying *value* it offers has therefore and by default gone UP, they sell it. Conversely, when the market has gone up – and as such the underlying value has gone down - they buy, *with relish and enthusiasm*. As Graham points out, those who react this way are turning their most basic advantage into a disadvantage. This is clearly irrational behaviour, and as such, WE don't do it.

In fairness, I've brushed some broad stokes in the statement above. It should include the caveat "…*all else being equal*". When is "all else" ever truly "equal" in the world of investing? Perhaps never. But this may not be the impediment you might think. The ever-changing and evolving factors impacting share prices, *in composite*, are *tailwinds* for stocks – not headwinds. Consider the historical growth rate of the stock market (around 10% per year, *on average*) as all the proof we should need. "All else" when it comes to *most* businesses isn't equal at all. Generally speaking, things get better and better over time.

"A cynic is someone who knows the price of everything and the value of nothing." - Oscar Wilde

Let's briefly look at a recent example of how this inverse relationship applies to a business and its fluctuating share price. In September 2018 shares of the Royal Bank (ticker RY) reached a high of $105.12. (Based on this information alone, we can say little about how the price relates to the actual underlying *value* of the business). On December 24 2018 – just three months later - RY shareholders (I hesitate to call them "investors") sold the stock ***down*** by 14.3% to a low of $90.10.

I think the cynic, looking at price only, takes a pessimistic point of view: the price just went down a lot. Meanwhile the superior investor, *ever mindful of the inverse relationship between price and value*, takes a far more opportunistic viewpoint: perhaps there's an actual bargain to be had here. .

Given such an extreme sell off in so little time, we don't need to know much about the underlying value of the business to know that the value *in relation to the current share price* just went UP by more than 14% - *all else being equal*. In other words, shares of Canada's largest bank had just gone on sale. But of course, as touched on above, all else is rarely ever equal.

The Royal Bank has a fiscal year end of October 31, so in November they reported their annual financial results. And what did those results show, that may have led to such a severe sell-off in its share price.

As of the fiscal year ending October 31, 2018 – *at a time when would-be investors were selling RY shares en mass* - the Royal Bank announced *record* annual profits of $12.4 billion. Of course, I don't know who was selling RY at the December lows. But here's my hunch: they knew (and reacted to, in a very irrational way) that the PRICE had just gone down by more than 14%. So while these would-be investors may have known all they needed to know about the price, they clearly knew nothing about the inverse relationship between price and value.

"The polar opposite of conscientious value investing is mindlessly chasing bubbles, in which the relationship between price and value is totally ignored." - Howard Marks

Buying or selling anything, without regard for its underlying value, is like playing poker while blindfolded. At every market extreme, it never ceases to amaze me how many so-called investors seem completely oblivious to the relationship between price and value. Indeed, when prices have significantly dropped they seem willing to sell at ANY price (…they likely had no semblance of the underlying value of what it is they were buying in the first place). That is how you get a company like the Royal Bank dropping more than 14% in just three months, *while earning record profits*.

Also, at extremes to the *upside*, would–be investors seem willing to BUY at any price; again, blind to any semblance of the actual value (if any?) of whatever it is they're clamoring for *this time*. To quote from Howard Marks once again:

"People should like something less when its price rises, but in investing they often like it more".

That is how, during the "tech bubble" you had stocks trading at $100 'today' for $1 of profit in the future, and now cannabis stocks - *with ZERO profits* - trading at prices reflecting 100% market share amidst hundreds of competitors (let alone the thousands more who are "unlicensed"!).

In truth, with no regard for value you can even lose money in a *great* business, if you pay too high a price. Conversely, even a poor business can be a reasonably good investment if the gap between its price, and whatever value exists, represents a sufficient margin of safety.

To conclude the above brief analysis, at time of writing RY shares had advanced almost exactly 20% from the December 24 low - when selling was rampant, AND when dollars were “on sale” for eighty cents.

We will not be among those who know the price of everything, and the value of nothing. *Price* is what you pay. It’s *value* that we’re looking for.