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Volatility: The dearest friend of Mr. Value

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In Ben Graham's par able of Mr. Market, he describes a very volatile fellow who is sometimes exuberant and is willing to buy stocks at any price and who is sometimes depressed and is willing to sell at any price. In contrast to this highly volatile fellow, Mr. Market, who buys high and sells low we can imagine a cool, calm and collected fellow Mr. Value. Mr. Value is willing to help Mr. Market when he needs it the most, especially at the extremes. When Mr. Market is desperate to sell at any price, typically very low, Mr. Value is happy to help him by buying them off him and when Mr. Market is desperate to buy at any price, typically very high, Mr. Value is happy to help him by selling them to him.

This way there is a very good partnership and complementary friendship between Mr. Market and Mr. Value. Majority of the traders, i.e. market participants who aim to make money from short-term trading positions in the market, can be classified as Mr. Market. The investors, i.e. market participants who expect to make money from long-term investments in the markets, can be classified as Mr. Value. Traders want stocks that will move quickly in their anticipated direction and investors want stocks that are available significantly below their intrinsic value.

In a clear bull market trend the traders tend to make quick money by using techniques such as, technical analysis, trend analysis, momentum etc. combined with leverage, i.e. buying on margin, using futures and options etc. All of these seem to work as long as a stable trend continues. When volatility strikes, i.e. the trend is not clear and markets keep going up and down with high unpredictability, the leveraged portfolios start making huge losses. This induces panic in the traders, it seems to them that the world is coming to an end, and they want to close out their positions; at any price.

This is when Mr. Value is at the happiest. Volatility is the friend of Mr. Value. Under such conditions a large number of companies are mispriced and available below their intrinsic value. He can pick and choose the best companies based on various fundamental criteria and buy them at a discount to intrinsic value. So what does Mr. Value look for?

He reminds himself that the value of the business lies in its **fundamentals**. He starts looking at companies with large sales and earnings. These are companies which hold an important position in the economy due to their sheer size. They are likely to be there even in difficult economic situations.

Next he looks for companies with **strong balance sheets**. Strong balance sheets give the stability to survive difficult financial conditions. The fact that a company has low debt makes it less vulnerable to bankruptcy. Also if it has spare cash and debt capacity it allows it to take advantage of gaining further importance in the economy by gaining market share and possibly engaging in merger and acquisitions activity on favourable terms. It allows the company flexibility to add value on both the asset side and the liability side in favour of the shareholders.

Next Mr. Value looks at companies that have shown **strong management** capability in terms of proper capital allocation. Companies that have strong capital allocation capabilities are able to enjoy the famous “economic moat” of Warren Buffett.

Under times of volatility companies with above characteristics have a higher likelihood of being available at fair prices or below fair prices. However, Mr. Value is extremely cautious and evaluates these companies conservatively before deciding that they are cheap.

If they are cheap in a realistic-conservative model then he does not hesitate to make large purchases and build a long-term position in a diversified portfolio of such companies selected on the basis of their strong fundamental economic and financial position and availability at a discount to intrinsic value.

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What Mr. Value does not do is start speculating on the chances of a further fall in the markets and specific stocks. He does not worry about the possibility that he makes a purchase and the market could fall further by 10 or 20% or more as long as the price he is paying is significantly below his conservative estimate of intrinsic value. He does not use margin or use leveraged short-term derivatives instruments to take his positions. He does not continue watching the market price of his stocks daily after purchasing and fret about the fact that he could have bought it at a lower price. If he has more money to allocate then he might add more to his position considering his overall asset allocation and near and long-term financial requirements.

He might decide apriori to stagger his purchases over next few days or weeks or months and then he sticks to that plan whether markets show an upward or downward trend. Of course, if the stock prices have gone above their intrinsic values then he needs to search for new stocks which are at a discount or come up with a new plan.

That, in sum, is how Mr. Value falls in love and tangoes with volatility and demonstrates his friendship to Mr. Market by helping him.