A Bird's Eye View
Sparrows Newsletter
December 2017

The Price Is Right

As a child, I loved TV shows. One of my favourites was "the Price is Right", in which the contestants compete to win cash and prizes by guessing the pricing of various items. First aired in 1956, the show (in its adapted format) is still televised worldwide, most notably in the United Kingdom, Australia and Mexico.

I am often reminded of this show when speaking to professionals in the financial sector. One of the common mantras in the industry is that "everything has a price". If you can buy something at the right price, you are, of course, in a good position to sell on it at a profit.
The principle is logical and intuitive, but ignores the difficulty of establishing the right price *at the time of making the transaction*. It is only with hindsight that we know whether the price we paid was, indeed, "right".

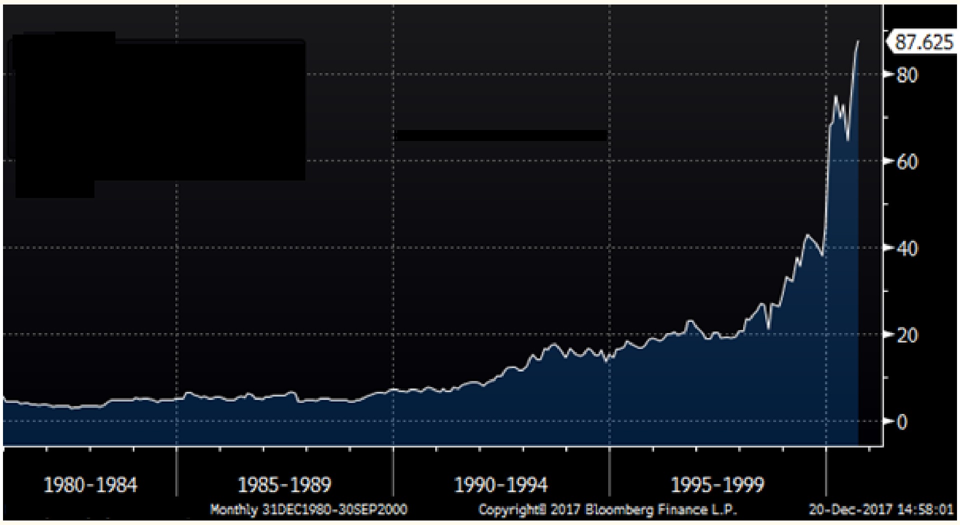
Every day, professional investors and investment managers strive to establish the right price for thousands of securities on exchanges around the world. Every trade requires two parties with diametrically opposing views: the seller assesses the clearing price as too high, while the buyer is confident he is acquiring the asset at an attractive level. They cannot both be right.

Can we establish, at the time of the trade, who is making the right call? Let us look at some examples.

Example 1:

Figure 1 shows the share price evolution of a US listed company over a 15 year period.

Figure 1



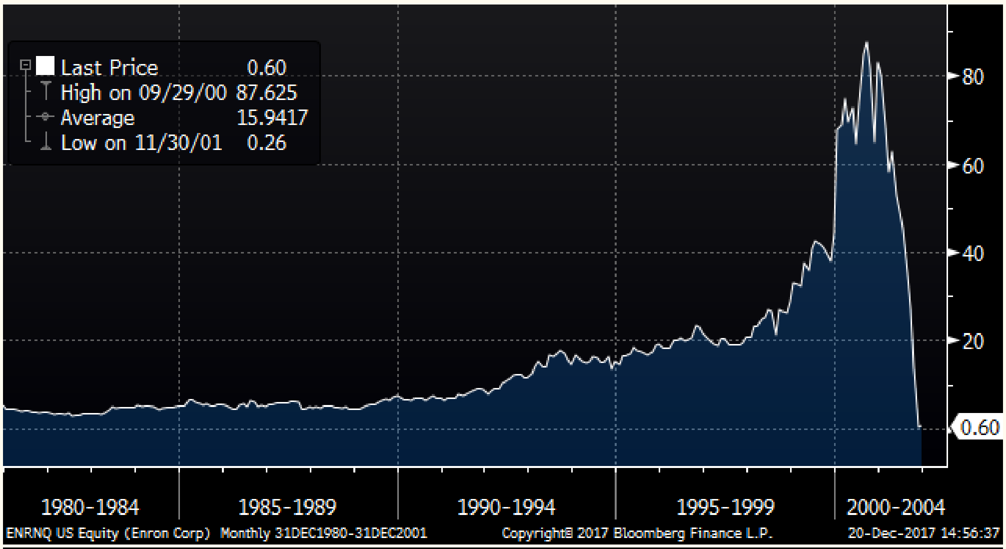
Over this time, shareholders saw the value of their collective ownership increase consistently, even exponentially. One can imagine the early investors telling their friends about this exceptional find whilst flipping through the latest yacht brochures.

But was $90 per share the right price tag for this company? An optimist might extrapolate past price trends and conclude that the enterprise must be worth far more than the current market valuation; after all, who wants to miss out on a party like this? But a pessimist might argue that the price reflects “irrational exuberance”, and that we should expect a substantial downward correction. Both sides can make compelling arguments to their views and projections, but which is right?

Today the company is worth precisely nothing, as any Enron shareholder knows only too well (see figure 2). Of course, with hindsight it is easy to find numerous papers showing that the writing was on the wall, and that the fall from grace was inevitable. Hindsight, as they say, is 20/20.

Of course Enron was an exceptional case. This was a company with a peak valuation in excess of $60 billion that cooked the books and vapourised the lifetime savings of many investors around the globe

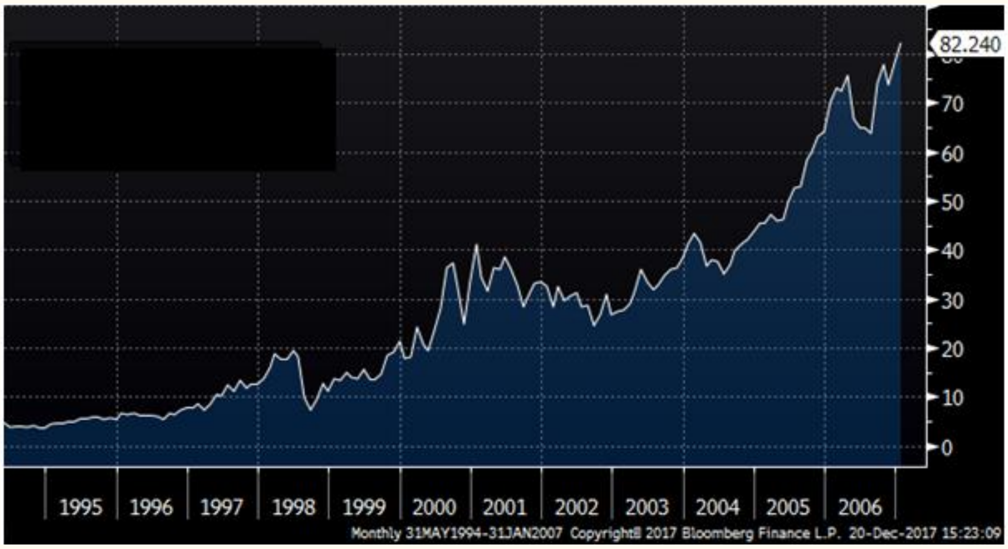
Figure 2



Example 2:

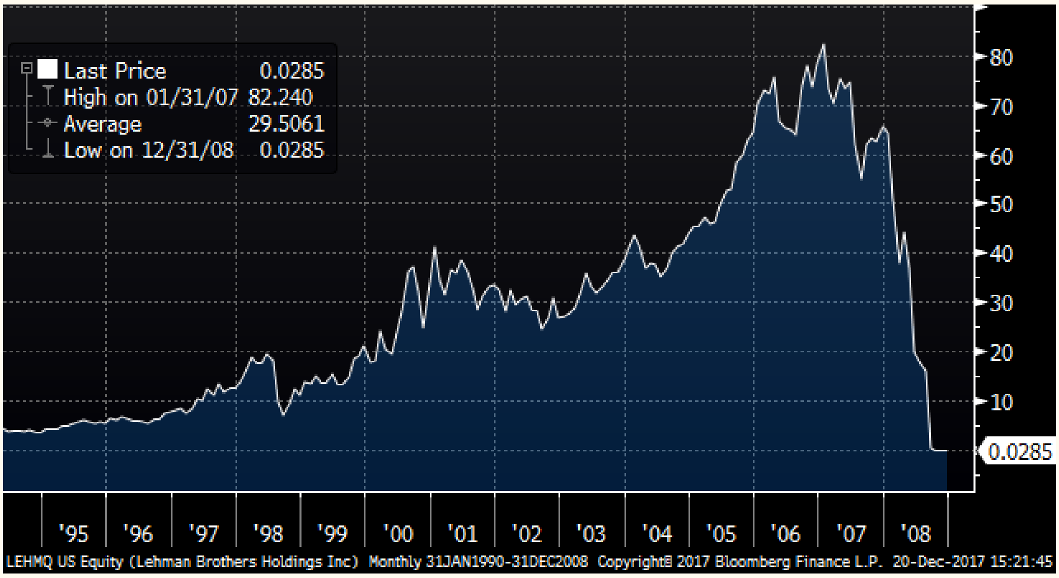
So perhaps the lesson is to try and avoid over-hyped firms, to stick to boring companies whose price grows gradually and persistently. On that basis, we should feel much more comfortable with the valuation of our next item (see figure 3), a firm that has been in operation for many decades, has survived many economic cycles and has increased its market capitalisation consistently over the long term. True, it is not as exciting a ride as the Enron experience, but surely, having proven its resilience over decades, it is an appropriate home for our nest egg?

Figure 3



Alas, wrong again. Unfortunately for many, this apparently steady company – which many thought too big to fail, has now assumed its place in history as one of the largest fatalities of the 2008 Global Financial Crisis. What, with hindsight, was the right price for this venerable institution with $639 billion in assets and 25,000 employees worldwide? Again - zero (see figure 4). The name of the company? Lehman Brothers.

Figure 4



There is another interesting observation we can make in the Lehman case: as the price fell, the shares continued to trade. Some traders were prepared to bet that a share that had been trading at over $100 *must* be a bargain at $40. One of the bitter beauties of statistics is that, no matter how much has been lost so far, one can still go on to lose 100% of the remaining value. In Lehman's case, a number of investors learnt that lesson the hard way.

Example 3:

Not all cases need to end as badly as these two extreme examples. Any bet on a price of any individual stock exposes you to an idiosyncratic risk that can manifest itself at exactly the wrong time. Investment losses are not limited to drastic events such as bankruptcy.

To demonstrate, let us take a look at a more recent example on a much smaller scale. In figure 5 you can see the price evolution of a firm operating in the technology sector over the past few years. The price fluctuates, but the trend is positive. We haven't doubled our money, but we haven't lost our shirts either. Do you want to guess the price for this firm today? (hint: it is not zero).

Figure 5

As investors in Imagination Technologies found on the morning of April 3rd 2017 the value of the company was significantly less than what they had paid for it just a day prior. On that day Apple Inc. announced its intention to develop its own chip designs and to stop paying royalty to their UK suppliers, Imagination Technologies. The share price plummeted over night by more than 60% (see figure 6).

Figure 6

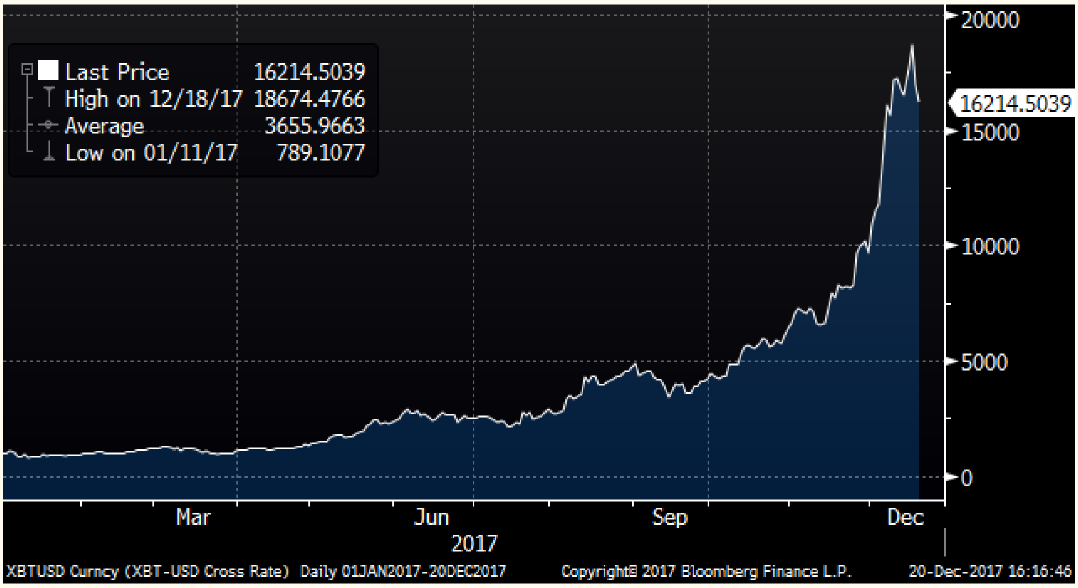
What was the fair price for a share of Imagination Technologies that day? Did the Apple announcement mark the firm's ultimate demise, following on the heels of Lehman and Enron? Or did the market overreact? Those who had patience found out in September that surprises come in different shapes. An announcement that Imagination Technologies had agreed to be acquired by private equity firm Canyon Bridge saw the stock price up more than 30 per cent overnight. With such aggressive volatility, how easy is it to establish the right price?

Example 4:

Bitcoin, the best known crypto-currency, is clearly flavour of the month for some investors. The price (but not necessarily the value) of Bitcoin over the past 12 months is depicted in figure 7, below:

Arguably the $1,000 January 2017 price already seemed quite aggressive and speculative for a collection of bytes with zero intrinsic value. Nevertheless, it had soared to just under $5,000 by late August, a remarkable return of 500% in just 8 months! One might expect investors to be eager to capitalise on such profit, and indeed some seem to have done so, as the price declined for two weeks during September. But those who did probably regret that decision today, as Bitcoin is trading at over $16,000 as I write.

Figure 7



Surely, the upside is now fully factored into the price of the cryptocurrency. Or is it? After all, some analysists are predicting Bitcoin's value at $50,000, a market value that would have been ridiculed only a year ago.

Welcome to The Price is Right! Come on down and guess the price!

So how can an investor engage with the markets without the benefit of hindsight and without a crystal ball? The good news is that the only reliable way to win this game is to stop playing it. Don't fool yourself that you can guess what the price should be, or pay someone else a hefty fee to guess it for you. The way to win this game is to buy the whole market – the index - at a price determined by the collective wisdom of all those who are playing the game. You can achieve this through ETFs or index funds at a surprisingly low cost.

Then all you need to do is sit back and watch others play the game...

Yariv Haim, Founder and CEO

For more information on our philosophy, process or if you just want to challenge these observations, please get in touch.

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