Client's Corner

The Myth of Instability

(Editor's note: This essay updates one originally published in Client's Corner*, April 2015.)*

AS I WRITE IN MID-JUNE, WITH THE STANDARD & POOR'S 500-Stock Index around 2,900, the market capitalization of its 505 component companies is about $24 trillion. Expressed another, perhaps simpler way: the sum total of the value in the marketplace of all the outstanding shares of these companies is $24 trillion, give or take.

If you can't even imagine what a number that large can possibly mean—and I can't either—let me offer one other statistic which may begin to put it into some comprehensible perspective. As of the end of this year's first quarter, according to the National Bureau of Economic Research, the Gross Domestic Product of the United States—the total value of all the goods and services produced here—was running at an annual rate of about $21 trillion.

Forgive me if I seem to belabor the obvious here, but let me spell out my point. ***What we have just established is that the value in the marketplace of the S&P 500 public companies exceeds by a considerable margin the value of all the goods and services produced in this country in the last 12 months.***

What inference do I hope you will take from that juxtaposition? Simply this: the notion that the **real, enduring value** of those 505 businesses is seriously unstable, and even volatile, is an absurdity on its face.

Note that I did not make any statement about the prices of those 505 ***stocks*** at any given moment. I said, and now say again: ***the idea that the intrinsic value of the companies is inherently and vulnerably unstable is silly.***

The distinction between the enduring value of companies and the shorter-term volatility of stocks is by no means academic or technical. Indeed, your ability to make that distinction even as stock ***prices*** gyrate sickeningly from time to time may determine your ultimate success or failure as an investor.

Let us now study a case in point. It will not have escaped your notice that in the three months and four days from September 20 of last year through Christmas Eve, the S&P 500 Index—***that is, the composite price of the 505 stocks***—went down 19.8%, with the media shrieking that this was the onset of a recession and a major bear market.

In the event, it turned out to be neither, but that is entirely irrelevant to the question I'm about to call. To wit: did you think for one moment on Christmas Eve that 505 of the largest, best financed, most profitable companies in the world ***had suffered the loss of 20% of their enduring value as businesses?***

Or were you instead inclined to the belief that—stocks being ***much*** more volatile than companies—the tail was, just at that moment, wagging the dog?

I offer a personal opinion: Stocks are far more volatile than companies. And investor emotions are the most volatile of all.

Again, it was your ability to distinguish between volatile stocks and stable companies that made the difference. If you had that ability—or if you didn't, but thank heaven your financial advisor did—you stayed the course. If you didn't…well, you didn't. And it is my painful duty to report to you that the Index at 2,900 is up about 23% since the orgy of panic selling that was Christmas Eve. (Add around 1% more for dividends in the intervening six months.)

You didn't have to know anything about trade policy, or interest rates, or the rate of GDP growth that quarter, or anything else. You just had to have some plain common sense—or, again, a good advisor. And you just had to ask each other: ***do we believe the ongoing enterprise value of these leading companies has diminished by 20% in the last three months?*** That question, asked just that way, answers itself.

After a little more than a half century in the capital markets, I offer a personal opinion: **Stocks are far more volatile than companies. *And investor emotions are the most volatile of all.***