

Hello, Mr. Market: Volatility in International Equity Indices

By Paul Ebreo

*It's easy enough to be pleasant
When Life goes by like a song,
But the man worthwhile,
Is the man with a smile,
When everything goes dead wrong.
-Anon*

Imagine waking up one morning to find that half of what you own is gone. It has disappeared overnight. All the money you've worked so hard to earn: poof, gone. This is what it feels like to be a Wall Street trader during these volatile times.

Why are people surprised when the stock market falls so suddenly? Hasn't this happened before? Isn't the stock market supposed to go up and down? The headlines should have said, "*Here We Go Again*" or, "*It Was Just a Matter of Time.*" But that's not how pundits frame it. There are always clever explanations. It is because of the slowing housing market. It is because of the sub-prime mortgage meltdown. It is because of oil prices. It is because of China. It is always something or another. But as one successful investor wisely observed, "*Who knows and who cares?*"

Meet Mr. Market

Believe it or not, there are a group of investors who see the market as a living, breathing, person. These quirky investors call him Mr. Market. Now, Mr. Market is obliging in that everyday he quotes you a price on any stock you wish. You are free to buy or sell from him. But he is a very emotional person. Some days he feels cheerful and quotes you high stock prices. Other days, he feels glum and quotes you low stock prices. Mr. Market is a manic-depressive.

Mr. Market is a news monger, he loves to hear the latest news on the economy, politics, and social issues. He lives for earnings reports, and Fed announcements. He feeds off interest rate hikes, and GDP growth, and all manner of economic metrics. He gets worked up on the day-to-day news. When he hears good news, companies can do no wrong and he prices stocks based on rosy scenarios. When he hears bad news, companies can do no right and he prices stocks on doomsday scenarios.

Question: *If Mr. Market were really a person, would you buy stocks based on his moods or would you make up your own mind?*

The thought of the market being so erratic and emotional really makes you think. But is it true? How often does the real-life market go up or down? We will find out.

But first a pop quiz. **What happens more often?**

A MAJOR STOCK MARKET DECLINE or **YOU GOING TO THE DENTIST**

We'll get to the answer in a moment.

But first take a look at Table 1. This table shows how often the Dow has dropped over certain periods. Notice that since 1929 the Dow has had a major drop (of 4% or more) in any given week, **896 times**. What does that mean? It means, on average, the Dow Jones Industrial Average has had a significant drop - like the one we are experiencing right now - once every five weeks. It means, on average, you wash your car more often than the Dow has a major "correction."

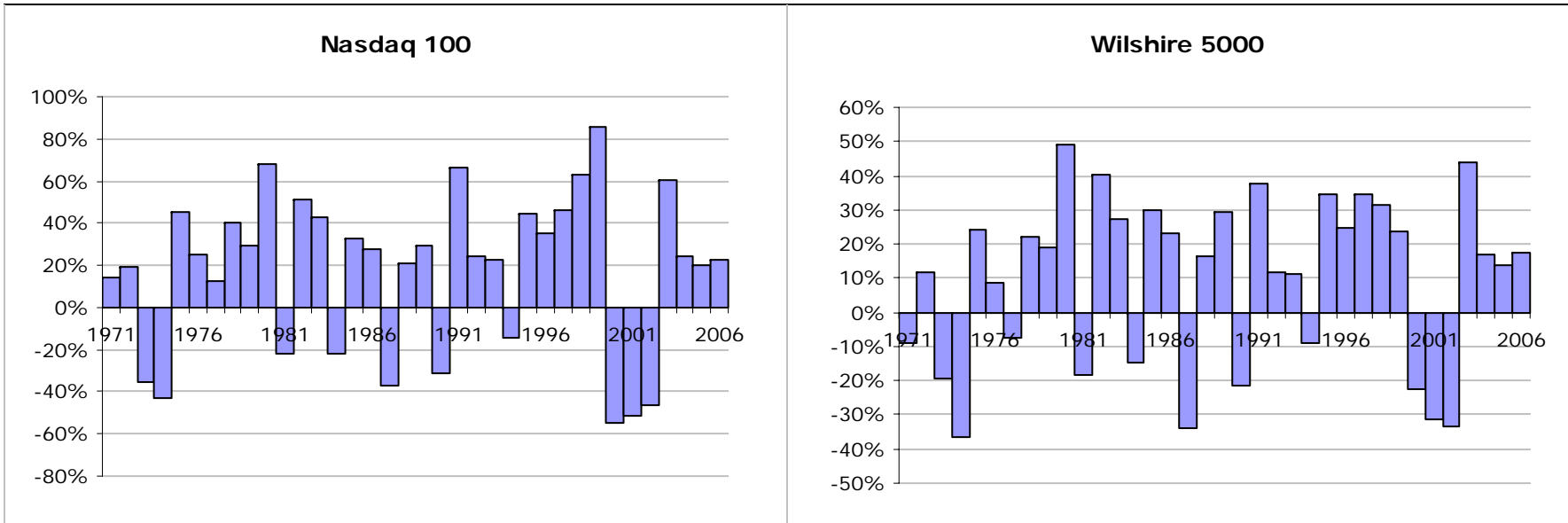
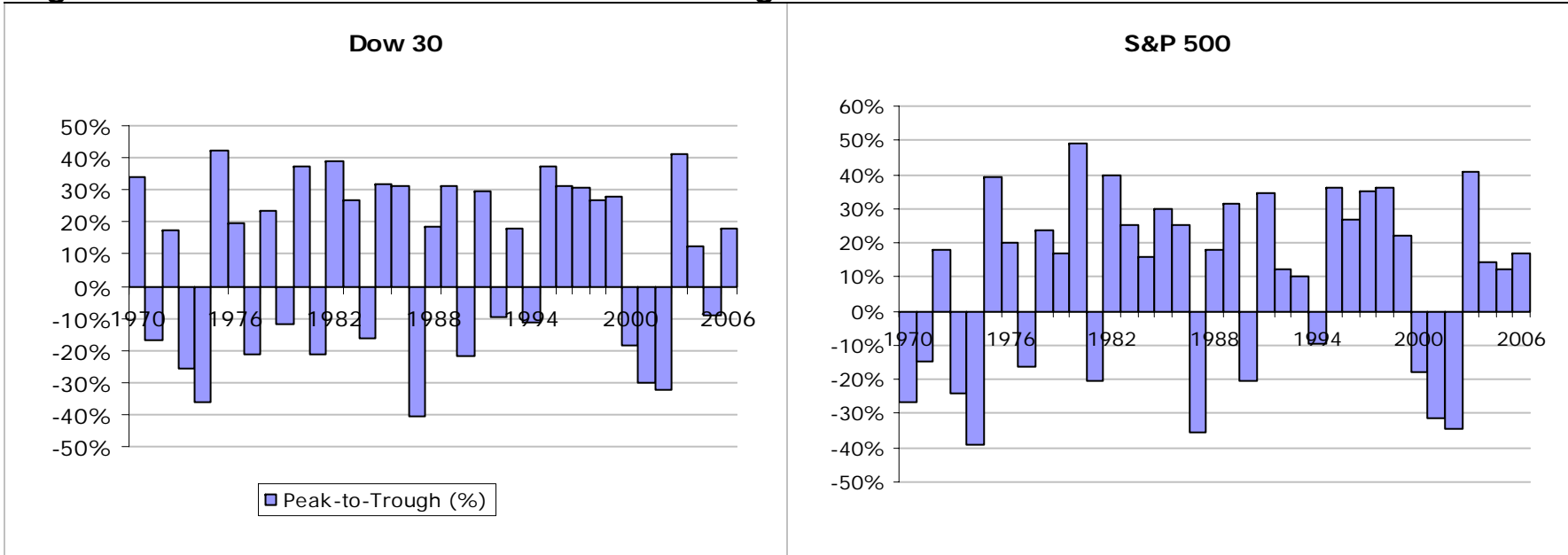
Period	Percentage of Weeks with Drops of at least four percent	# of Weeks with Drops
1929 – March 2007	22%	896
1929 - 1933	81%	210
2000 – 2002	60%	89
2003 – March 2007	9%	19
2006	4%	2

Source: Yahoo! Finance; calculations are mine

And now our answer to the question: What happens more often: a visit to the dentist or a significant drop in the stock market? According to the California Dental Association, you should see your dentist twice a year for regular checkups. Since, on average, the stock market drops significantly at about 5 times a year, you are 3 times more likely¹ to see a drop in the market than you'd see your dentist!

¹ About 5 times a year because the inverse of 22% (1/0.22) is 4.5. And about three times more likely because 5 divided by 3 is 2.5.

Figure 1. US Market Indices: Peaks and Troughs



Source: Yahoo! Finance; calculations are mine

Peaks and Troughs

So it's true that markets reach extremes, but how often do these extremes occur? Take a look at Figure 1. This table shows the yearly peaks and troughs of the different incarnations of Mr. Market: the Dow, the S&P, the Nasdaq, and the Wilshire 5000. Think of market movements as waves in an ocean. Sometimes the waves are calm, and other times they are violent. But no matter what, the waves are always there. Figure 1 shows the peaks and troughs of these market waves. As you can see, in any given year, the market is surprisingly turbulent.

Let us look at an example. In 1999, the Nasdaq had a trough price of 2,192 on January 4th and a peak price of 4,079 on December 30th. the peak-to-trough for that year was 86% $[(4079/2192)-1]$. The following year, the Nasdaq had reached a peak of 5,060 points on March 10th, and a trough of 2,288 points on December 22nd. The peak-to-trough for that year was -55% $[(2288/5060)-1]$. Since the trough came after the peak for that year we have a negative peak-to-trough number. When a negative peak-to-trough appears 2 years in a row, it usually means a major market sell-off.

The world isn't immune to Mr. Market's manic-depression. From Bombay to Berlin, Mr. Market is always ready to change his mind. It seems the more places he can be fickle, the more extreme can be his moods. For example, on October 22, 1987 the Australian ASX Index lost 585 points in one day. On May 17, 2004, the Indian BSE lost 793 points in one day. The Dow lost 487 points on October 19, 1987. Mr. Market is just as manic-depressive, if not more, in foreign countries as in the US. (See Table 2.)

Table 2. Mr. Market Around The World: Severe One-Day Declines

Country & Index	One-day Decline	Date of Decline
Australia - ASX	27%	October 22, 1987
Brazil - BOVESPA	29%	January 15, 1999
Canada - TSX	7%	April 4, 2004
China - SSE	9%	February 17, 2000
Germany - DAX30	10%	July 24, 2002
India - BSE 30	16%	May 17, 2004
Israel - TASE 100	11%	December 16, 1998
Japan - NIKKEI 225	15%	October 20, 1987
S. Korea - KOSPI	10%	December 16, 1998
UK - FTSE 100	12%	October 20, 1987
US - Dow 30	22%	October 19, 1987
US - S&P 500	20%	October 19, 1987
US - Nasdaq 100	15%	April 4, 2002
US - Wilshire 5000	8%	July 24, 2002

Source: Yahoo! Finance; calculations are mine

If there's one person who knows about ruinous declines in the stock market its Ben Graham.

The Father of Value Investing

In 1914, a bright young man named Ben Graham graduated Columbia University with a degree in classics. He was ready to tackle the world. He was so talented that he was offered departmental jobs in mathematics, philosophy, or English. He couldn't decide. The dean of his college suggested he go to Wall Street, and that's where he went.

Graham's first job on Wall Street was at the bottom of the totem pole. His first job was chalking on the blackboard for a modest \$12 a week. He worked his way up as a "statistician" – what analysts were called in those days – and by the late 1920s he taught evening classes on finance.

Graham had a talent for numbers. He had learned to apply this talent by finding stocks that were cheap and safe. One stock he thought was cheap was Northern Pipe Line – a company owned and operated by the Rockefellers. The stock was selling for \$65 when Graham bought it. Graham calculated that Northern Pipe Line had assets worth at least \$95 per share. After joining the board of directors and twisting their arm he sold the stock for a 150% gain.

By 1929, Graham had a reputation as someone who knew how to make money on Wall Street. He formed his own research firm and started a private investment partnership which had total assets of \$2.5 million – which is about \$40 million in today's dollars. Graham was a cautious investor. When the market crashed in 1929 his partnership only lost 20 percent. Like many others on Wall Street, Graham thought the worst was over. He was wrong. He sought to jump on the opportunity that the market crash gave him and borrowed money to buy more stocks. By 1932, the stock market had plummeted further and his partnership lost 70 percent of its total assets. Graham was nearly ruined.

After his near bankruptcy, Graham and his family moved from their Manhattan duplex to a small apartment across town. His wife went back to work as a dance teacher and Graham got back to writing and teaching. Though he was bruised and bloodied, Graham did not give up on stock picking. A good friend, Jerome Newman, put up \$75,000 to keep his investment firm alive. Graham continued to run his firm and write research reports for no salary. For five years Graham didn't get paid.

For 20 years until the 1950s, Graham had quietly and slowly built up his partnership again. During the 20 years after the crash Graham never gave up on his system of buying stocks below his calculated value of them. He taught at Columbia University where he generously shared his experiences, his philosophy, and – to the delight of his students – his stock picks.

One of his students recalls, “He was giving you ideas. Youngstown Sheet & Tube I bought at 34 5/8 and sold between 75 and 80...[That] class paid for my degree.”

Graham was a captivating teacher. He was low-key and reserved but his teaching methods were dramatic and exciting for something so mundane as finance. He taught classes like medical case studies. In a typical class, he would put two completely different financial statements side-by-side and surprise his students by revealing that the numbers were from the same company. Another technique he used was to present the financials of a company throughout different stages of its life. He would present the company when it was failing and when it was succeeding. Financial statements came to life in Graham’s classroom.

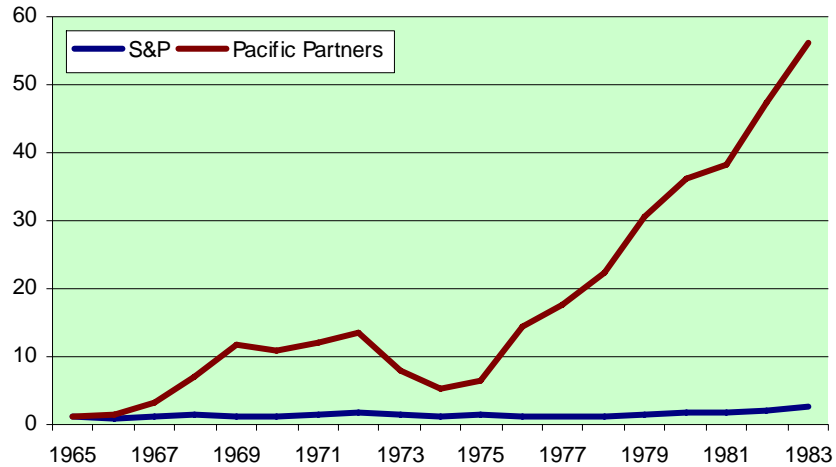
Graham focused his teachings on analyzing *companies first* then on stock prices. How and what he taught bucked conventional wisdom and that made him popular among his impressionable students. Graham enjoyed interacting with his students. It was typical for him to ask open-ended questions and encourage his students to think independently – a trait uncommon on Wall Street.

In 1949, Graham published *The Intelligent Investor*, a layman’s guide to investing in stocks. In this book, he boiled down his stock-picking method and philosophy into three simple truths. First, he believed that the movement of the stock market was not there to instruct you, but rather, was to be taken advantage of. Essentially he said, ‘**Mr. Market is your servant, not your master.**’ Second, he believed that stocks were pieces of businesses, not ticker symbols that moved independently of the underlying business. In essence he said, ‘**You buy stocks based on businesses considerations, not because of the fads or fashions of the moment.**’ And third, he believed that since the future was inherently unpredictable you have to buy-in at prices with room for error; you have to buy stocks with a **Margin of Safety**. To this day, Graham’s ideas are etched in every Value Investor’s mind.

Graham's Disciples: Investors That Beat The Market

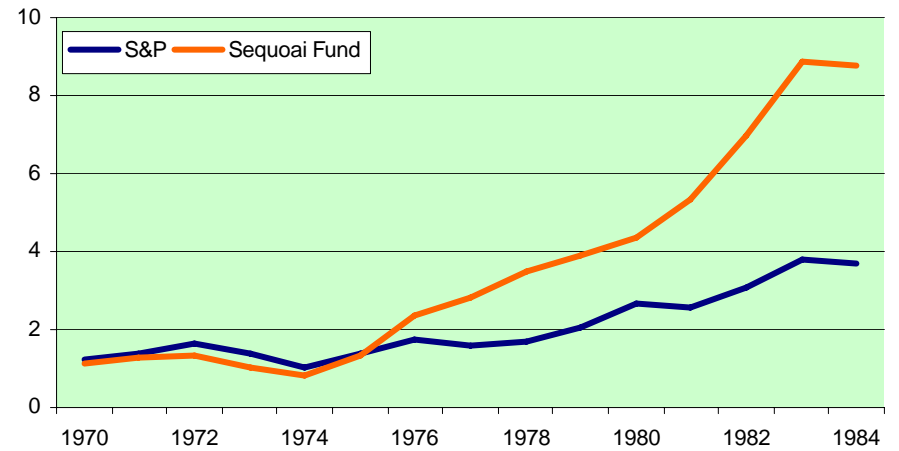
Pacific Partners v. S&P

Managed by Rick Guerin



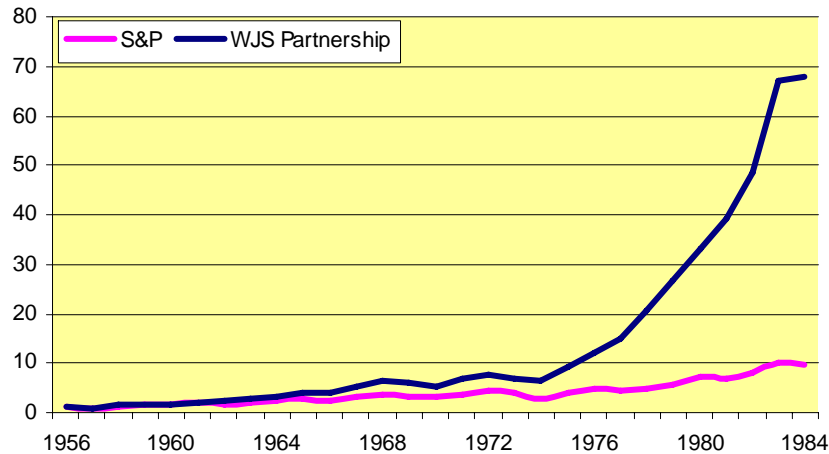
Sequoai Fund vs. S&P500

Managed by Bill Ruane



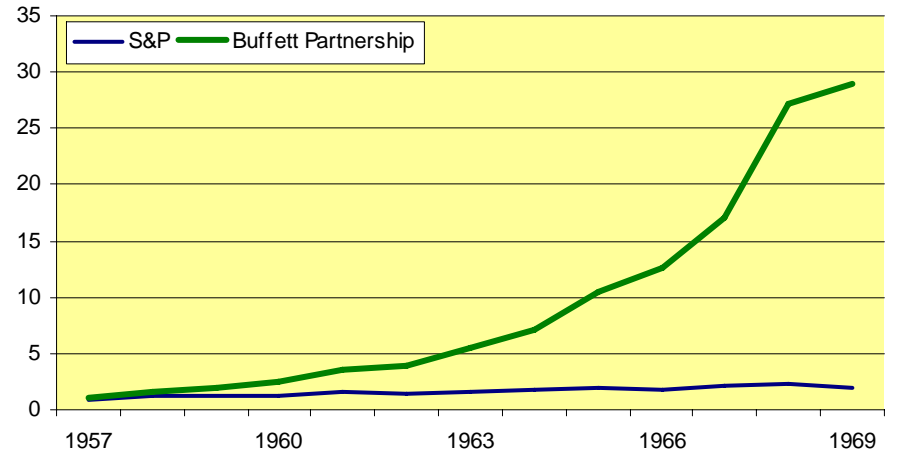
Walter J. Schloss Partnership v. S&P

Managed by Walter J. Schloss



Buffett Partnership v. The Dow

Managed by Warren Buffett



Graphs showing the growth of a hypothetical investment of \$1 versus the Dow or S&P. Source: May 17, 1984 speech by Warren Buffett celebrating the birthday of Benjamin Graham

The Investors That Beat The Market

One of the proudest moments in a teacher's career is knowing that your students have succeeded. In 1987, to commemorate Ben Graham's birthday, Warren Buffett gave a speech titled "The Super Investors of Graham-and-Doddsville." This speech was a reiteration of the core principles of Value Investing espoused by Ben Graham and his co-teacher David Dodd. It was also a refutation to the Efficient Market Theory which stated that the markets were efficient and that any success was by mere luck. To refute the random-success hypothesis, Buffett presented several records of Ben Graham's students.

Four of the examples that stood out were the records of Walter J. Schloss, Rick Guerin, Bill Ruane, and Buffett himself. Taken together these three outperformed the market by at least 1,400%. Buffett mentioned that all four men had chosen different stocks and all three had varying yet exceptional results. Though differing in their stock selection methods, what these three men had in common was their application of Graham's core principles of Value Investing. And the other records he showed were not-to-shabby themselves. (See Appendix C.)

Volatility, I Embrace Thee

When Galileo proclaimed the earth was not the center of the universe he was thrown in prison and left to rot². People violently rejected the notion that the earth was spinning and hurdling through space - it was too counterintuitive. It's easy to understand why they rejected this notion. Do you feel like your moving thousands of miles an hour on a spinning spheroid called Earth? Of course not. Galileo dared to challenge the *intuitive but incorrect assumption* that the Earth was the center of the universe. Only after the acceptance of Galileo's heliocentric model did human understanding of the cosmos progress.

In the spirit of Galileo, I propose a painful but necessary shift in your perspective:
Volatility is good for investors.

To help you accept this truth, keep in mind these three images:

1. Mr. Market. Realize that the short term fluctuations are due to the emotional throws of a manic-depressive man named Mr. Market. We have seen this from the data. We have seen

² Later his sentence was commuted to house confinement.

countless examples when Mr. Market sells cheap and buys dear. Volatility happens. Declines happen. Expect them.

2. Sea sickness. Just like the waves of the sea, the ups and downs of the market can be beneficial but they can also cause *mental nausea*. The waves are always there and you cannot tell when you'll encounter a storm or calm. Be careful not to get swept away by the waves of mania and panic!

3. Ben Graham and his students. Whenever you think you are down and out, just think of how Ben Graham stuck it out after the depression and how he persevered through tough times. Because of his experience with adversity, his focus on valuing stocks as business, and his long-term perspective, Graham prospered. The intellectual camp of Graham has applied his principles and has continued to thrive for over 50 years. Remember people like Warren Buffett, Walter Schloss, and Rick Guerin, who prospered because of Graham's teachings.

Conclusion

Let us conclude with a story. A man sees a stranger groping around in the dirt. "What are you looking for?" asks the man. "My keys," replies the stranger. The man kneels down to help search. "Where was the last place you saw them?" asks the man. "I saw them in my house," says the stranger. "Then why are you looking here?" asks the man. "Because," answers the stranger, "the light is better here."

This old Zen koan illustrates the most important 'truth' about investing: focus your time and energy on things that will contribute the most to your investing success. It's so easy to pay attention to the day-to-day gyrations of the market. It's so tempting to listen to the gossip about interest rates, quarterly GDP growth, consumer sentiment, and other macro indicators. However, do not get distracted by the daily noise. Do not get swept away by the cheery consensus or the panicked exits. Pay no attention or you'll be that man groping around in the dirt.

Appendix A – Extreme Peaks and Troughs

International Indices: Extreme <i>Daily</i> Peaks and Troughs				
Country & Index	Highest Weekly Peak	Date of Peak	Lowest Weekly Trough	Date of Trough
Australia - ASX	11%	November 13, 1987	-27%	October 23, 1987
Brazil - BOVESPA	33%	May 20, 1994	-29%	January 15, 1999
Canada - TSX	11%	February 4, 2000	-12%	October 26, 2000
China - SSE	14%	December 29, 2006	-10%	February 28, 2007
Germany – DAX30	17%	March 21, 2003	-17%	October 2, 1998
India – BSE 30	18%	May 19, 2004	-13%	September 14, 2001
Israel – TASE 100	6%	October 15, 1998	-12%	December 16, 1998
Japan – NIKKEI 225	16%	October 2, 1990	-15%	October 20, 1987
S. Korea - KOSPI	22%	December 5, 1997	-15%	December 12, 1997
UK – FTSE 100	12%	November 12, 1987	-15%	October 23, 1987
US – Dow 30	29%	October 31, 1929	-22%	July 21, 1933
US – S&P 500	19%	October 21, 1987	-14%	September 21, 2001
US – Nasdaq 100	22%	April 7, 2000	-22%	April 14, 2000
US – Wilshire 5000	11%	October 21, 1987	-11%	April 14, 2000

Source: Yahoo! Finance; calculations are mine

International Indices: Extreme <i>Weekly</i> Peaks and Troughs				
Country & Index	Highest Monthly Peak	Date of Peak	Lowest Monthly Trough	Date of Trough
Australia - ASX	16%	March 24, 1988	-45%	October 30, 1987
Brazil - BOVESPA	178%	January 31, 1994	-90%	March 31, 1997
Canada - TSX	13%	February 17, 2000	-19%	October 26, 2000
China - SSE	43%	January 24, 2007	-24%	January 29, 2002
Germany – DAX30	24%	January 18, 2000	-32%	September 21, 2001
India – BSE 30	26%	January 11, 1999	-27%	October 19, 2000
Israel – TASE 100	22%	January 7, 2002	-23%	October 26, 2000
Japan – NIKKEI 225	27%	August 31, 1992	-24%	August 24, 1990
S. Korea - KOSPI	63%	January 30, 1998	-34%	October 31, 1997
UK – FTSE 100	18%	January 31, 1989	-33%	October 28, 1987
US – Dow 30	44%	August 29, 1932	-44%	October 29, 1929
US – S&P 500	22%	October 31, 1974	-34%	October 20, 1987
US – Nasdaq 100	35%	April 19, 2001	-37%	October 28, 1987
US – Wilshire 5000	18%	October 22, 1982	-31%	October 26, 1987

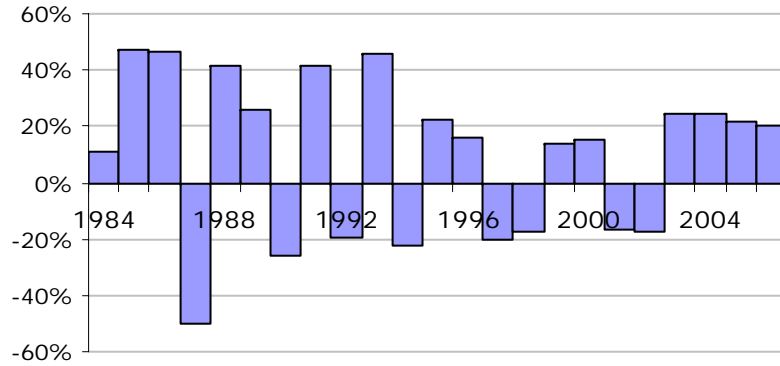
Source: Yahoo! Finance; calculations are mine

Appendix A (continued) – Extreme Peaks and Troughs

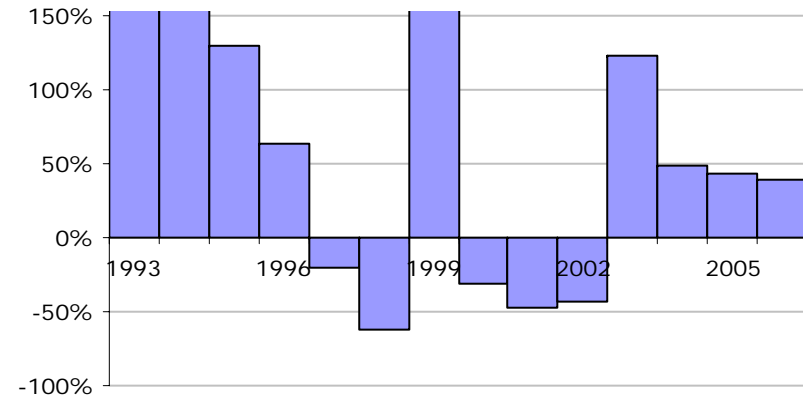
International Indices: Extreme <i>Yearly</i> Peaks and Troughs				
Country & Index	Highest Yearly Peak	Date of Peak	Lowest Yearly Trough	Date of Trough
Australia - ASX	47%	October 25, 1985	-50%	November 11, 1987
Brazil - BOVESPA	1,484%	December 30, 1993	-63%	September 11, 1998
Canada - TSX	42%	September 5, 2000	-33%	September 21, 2001
China - SSE	130%	December 29, 2006	-32%	October 22, 2001
Germany – DAX30	81%	December 30, 2003	-54%	October 9, 2002
India – BSE 30	102%	December 30, 2003	-43%	October 19, 2000
Israel – TASE 100	77%	December 31, 2003	-32%	November 5, 2002
Japan – NIKKEI 225	52%	December 30, 2005	-49%	October 1, 1990
S. Korea - KOSPI	112%	July 12, 1999	-56%	December 24, 1997
UK – FTSE 100	37%	December 31, 2003	-38%	November 10, 1987
US – Dow 30	119%	July 19, 1933	-63%	December 17, 1931
US – S&P 500	49%	December 1, 1980	-39%	October 4, 1974
US – Nasdaq 100	86%	December 30, 1999	-55%	December 21, 2000
US – Wilshire 5000	49%	November 28, 1980	-36%	September 30, 1974
Source: Yahoo! Finance; calculations are mine				

Appendix B. International Indices – Peaks & Troughs: Australia, Brazil, Canada, and China

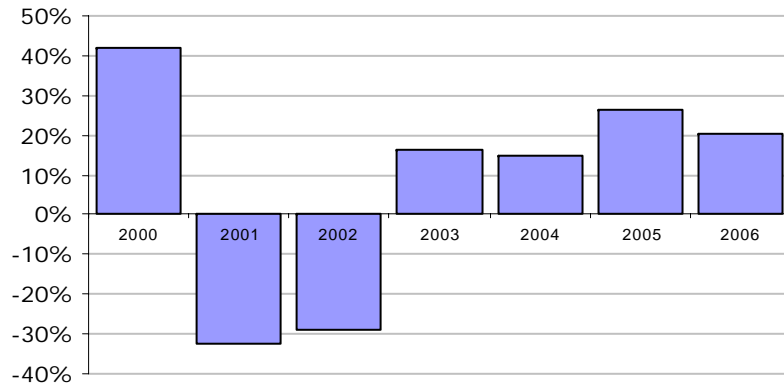
Australia - ASX



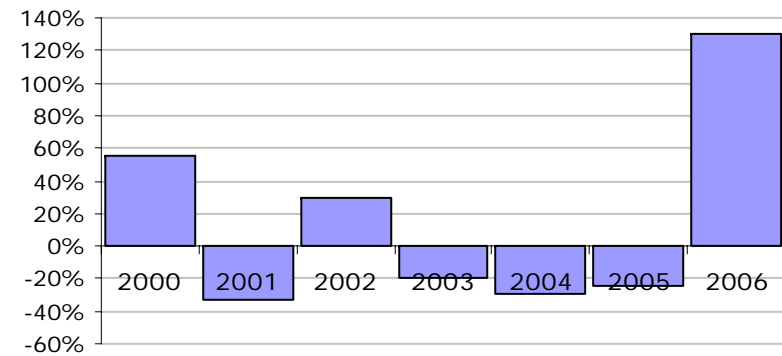
Brazil - BOVESPA



Canada - TSX



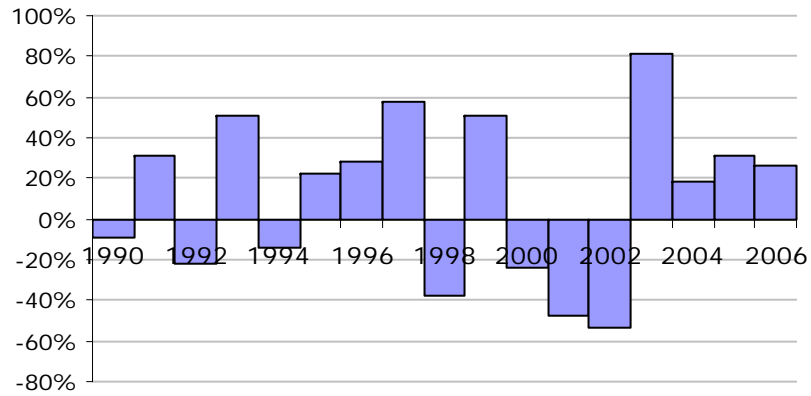
China - SSE



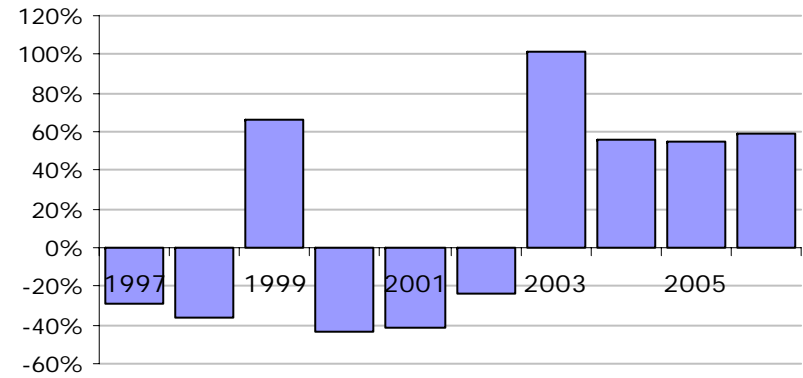
Source: Yahoo! Finance; calculations are mine

Appendix B. International Indices – Peaks & Troughs: Germany, India, Israel, and Japan

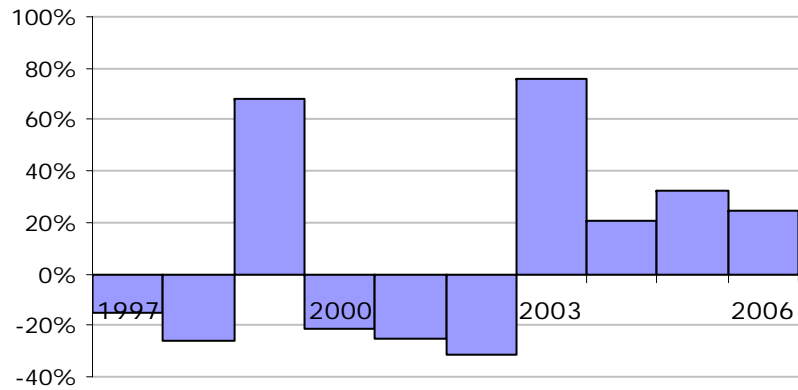
Germany - DAX 30



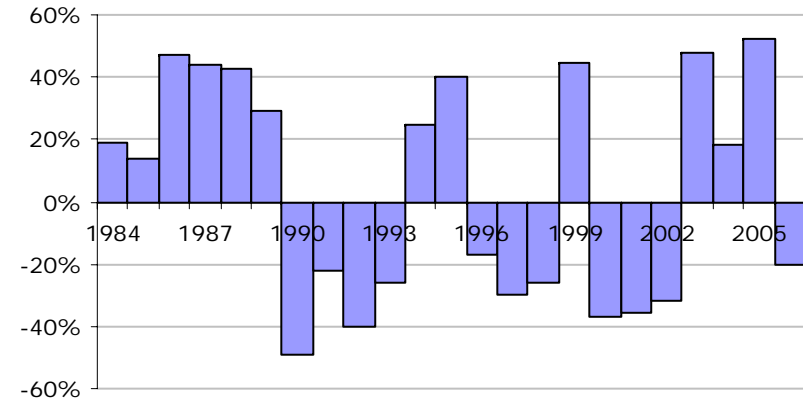
India - BSE 30



Israel - TASE 100



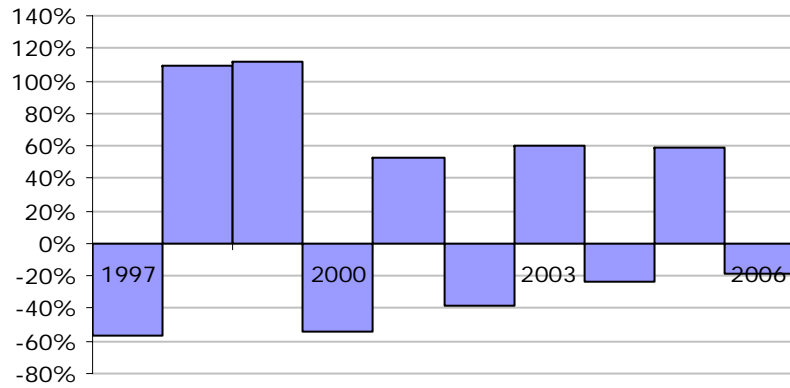
Japan - NIKKEI 225



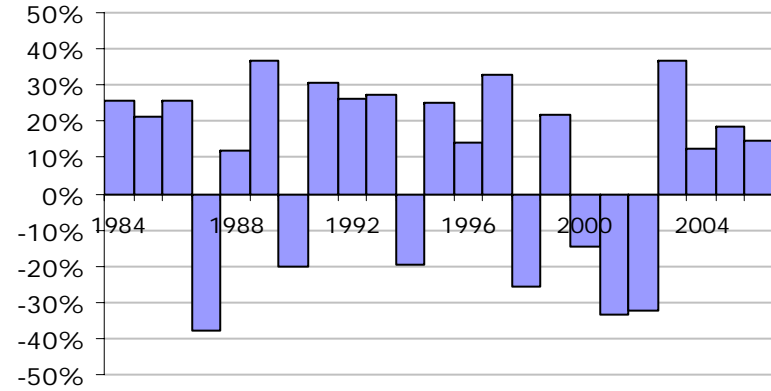
Source: Yahoo! Finance; calculations are mine

Appendix B. International Indices – Peaks & Troughs: South Korea, and United Kingdom

South Korea - KOSPI



United Kingdom - FTSE 100



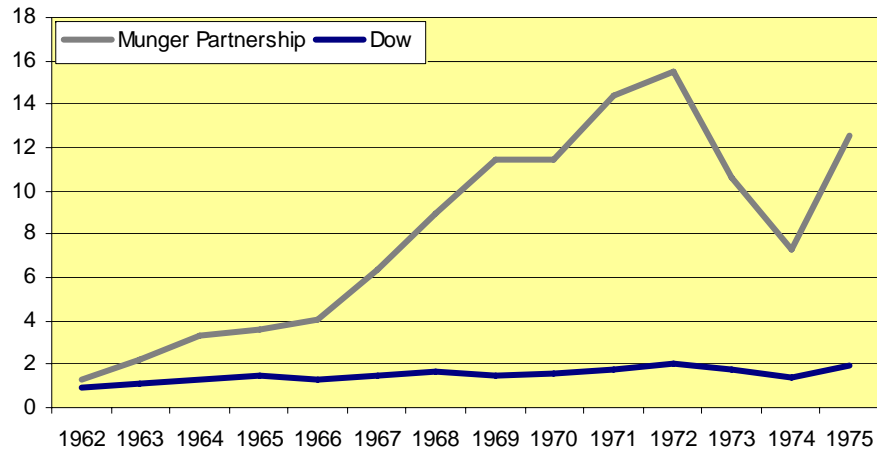
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Appendix C. More Graham Disciples: Munger, Weitz, Whitman, and Greenblatt

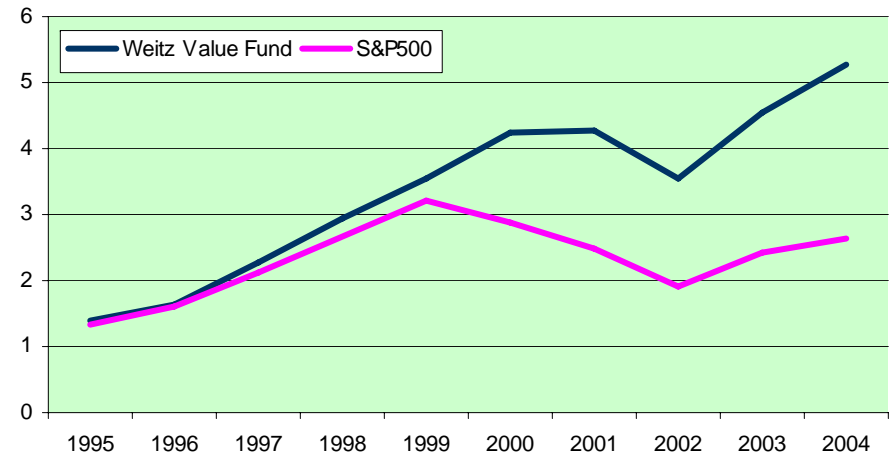
Munger Partnership

Managed by Charlie Munger



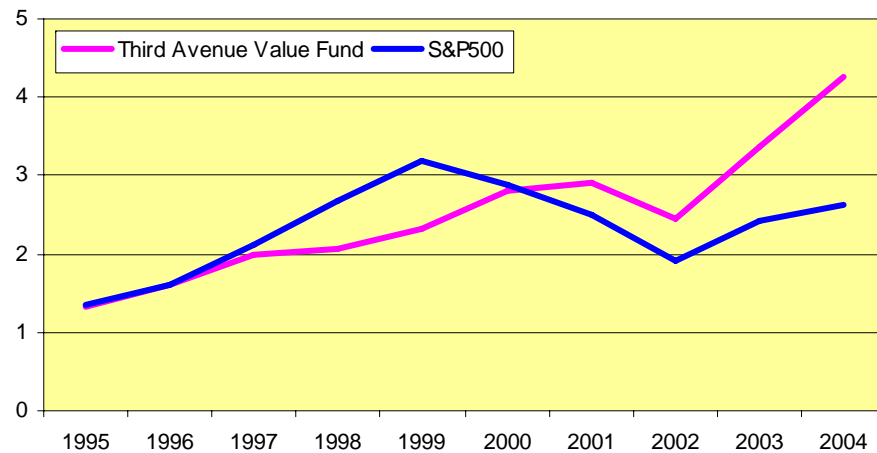
Weitz Value Fund

Managed by Wally Weitz



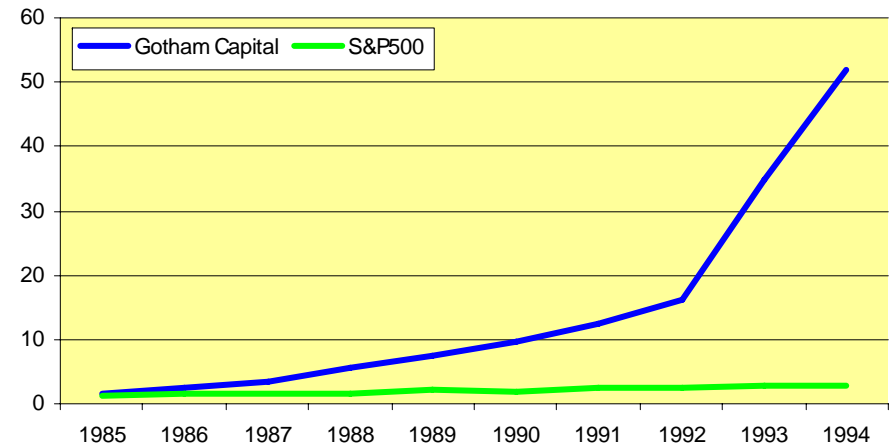
Third Avenue Value Fund

Managed by Marty Whitman



Gotham Capital Partners

Managed by Joel Greenblatt



Graphs showing the growth of a hypothetical investment of \$1 versus the Dow or S&P. Sources: May 17, 1984 speech by Warren Buffett celebrating the birthday of Benjamin Graham; various fund prospectuses; *You Too Can Be A Stock Market Genius* by Joel Greenblatt