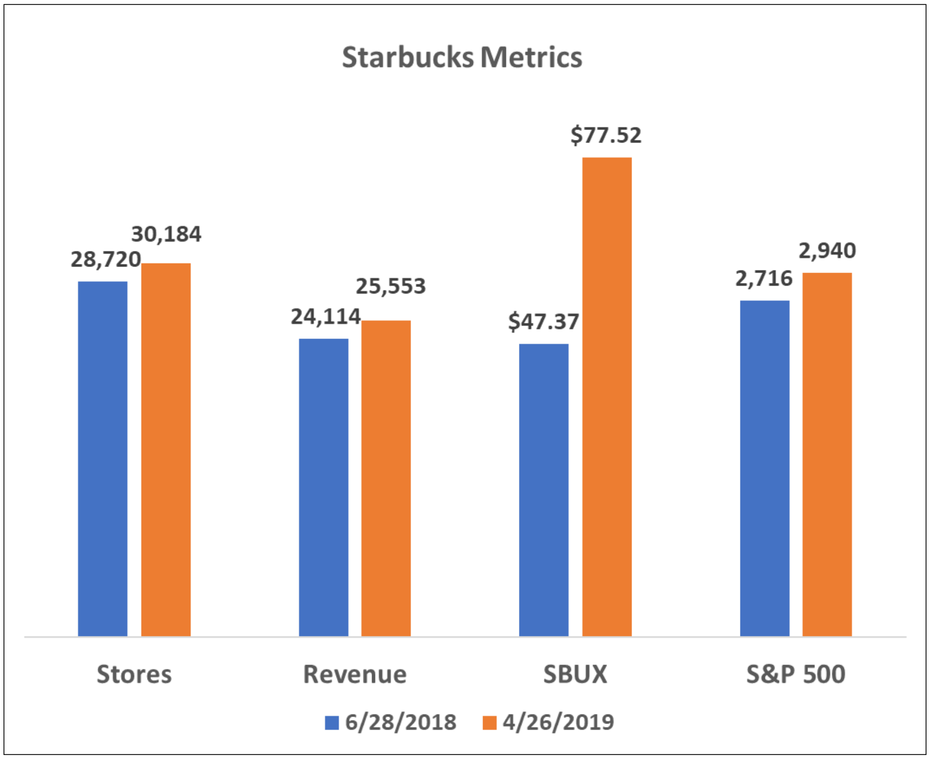
Mr. Market Is a Crazy Man

As we write this, Starbucks' stock (SBUX) reached its highest-ever price. At about $77 per share, and with 1.25 billion shares outstanding, the equity value of the company is about $97 billion. Just 10 months ago, though, SBUX stood at $47, which means that owners of Starbucks have seen their investment appreciate 64% in less than one year. The market cap of the company is now $35 billion higher than it was a short while ago. That's a bit staggering, isn't it?

In that same time frame, the number of Starbucks locations worldwide has increased about 5%, from a little less than 29,000 last summer to now about 30,000. Revenues for the trailing four quarters currently stand at about $25.5 billion, up 6% from mid-2018.

So what gives? The company has been around for more than three decades, its heyday of go-go growth is long behind it, and it's currently on a relatively mild mid-single digit growth trajectory. We know that a rising tide lifts all boats, but the S&P 500 is only up 8% in that same time frame. So how can Starbucks be up 64% in the last 10 months?



source: www.sec.gov, Inkwell analysis

The short answer is that Mr. Market is a crazy man.

Who Is Mr. Market?

Perhaps you are already acquainted with Mr. Market, but if you are not then we'll allow Benjamin Graham to introduce him to you. After all, Professor Graham is the one who invented him, so it seems only fitting:

> *Imagine that in some private business you own a small share that cost you $1,000. One of your partners, named Mr. Market, is very obliging indeed. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy you out or to sell you an additional interest on that basis. Sometimes his idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly.*

That is a direct quote from Chapter 8 of Graham's masterpiece The Intelligent Investor. Of The Intelligent Investor in general, Warren Buffett has said that it is "by far the best book on investing ever written." And of Chapter 8 specifically, Buffett has said, "Chapters 8 and 20 have been the bedrock of my investing activities for more than 60 years. I suggest that all investors read those chapters and re-read them every time the market has been especially strong or weak."

The trick is to figure out whether Mr. Market is feeling enthusiastic or fearful when quoting you a certain price. In our example, was the $47 Mr. Market was offering to pay for Starbucks stock last summer a fair price, or was it during one of his fits of melancholy? And is today's $77 a fairer assessment of Starbucks' true worth, or is it just a symptom of Mr. Market feeling particularly ebullient these days?

If you can figure out which mood Mr. Market is in when you look at a particular stock's price, then you are well positioned to take advantage of this, because if there's one thing you can take to the bank it's that Mr. Market's mood will definitely swing, and sometimes violently so.

Sometimes Mr. Market is Right

Just because a stock has risen or fallen dramatically in the recent past does not necessarily mean that Mr. Market is acting capriciously. There can be good reasons for stock prices to vacillate wildly. Perhaps an early-stage pharmaceutical company will have most of its future fortune resting on the successful launch of a promising new drug. And perhaps that drug will have sailed through the first few rounds of testing, and investors will grow more and more confident in the company's financial prospects, thus bidding up the price of its shares. But if it the drug suddenly fails a big trial due to some unforeseen calamity, that surprise could cause Mr. Market to completely wipe out his estimated value of the company.

Another possible explanation for wild price swings of a stock is a heavy debt load. For instance, let's say a particular stock has a total market cap of $1 billion. If the company also has outstanding debt obligations of $9 billion, then any potential acquirer of the company would have to shoulder a $10 billion purchase price to buy it outright. The normal parlance is that this company has an enterprise value of $10 billion.

If a certain event occurs that causes Mr. Market to rightly adjust his valuation of the company down by 4%, then the enterprise value would have to become $9.6 billion. A 4% change in a company's value is a completely normal occurrence that happens from time to time. But that small change in overall value can be disastrous to the people who own the stock. How so? Well, the debt that the company owes is still the debt that the company owes, so that figure is going to stay at $9 billion no matter what. Which means that the only way for things to make sense is for the equity value to decline from $1 billion to $0.6 billion, effectively wiping out 40% of the value of stockholders.

What Is Your House Worth?

The important thing to keep in mind is that Mr. Market is there to serve you, not to guide you. You are completely free to ignore the quotations he presents to you each day. One other thought exercise that can drive home this concept is to think about the value of your house.

Let's say you recently purchased your house, and that you paid $600,000 for it. You move in, you take a few weeks to unpack your boxes, you're starting to feel at home, and then one night the doorbell rings. It's a nice fellow who introduces himself as Mr. Market. He says, "I know you just moved into this house, but I really like it a lot and I'd love to live here myself. I'll pay you $700,000 for it if you can move out tomorrow."

Well, now you and your spouse are going to have quite an interesting conversation tonight. Moving is a pain. And such a chore. And there's frictional costs to doing it, like hiring movers, and whatever rent you would have to pay while you look for a new place to buy. So let's say you pass on the offer.

Then a couple of months later, Mr. Market is back on your doorstep and he's back in the market for a house. But this time he's worried about the manufacturing plant in the next town over that announced it will be closing next year, and he's heard that the principal of the highly rated local elementary school will be moving, and there's a new development going up nearby that's going to increase the housing supply in the area, so now he's only willing to pay you $400,000.

We won't belabor the metaphor, but hopefully this helps you see that Mr. Market can often let his emotions get the better of him. He can be overly enthusiastic at some times, and he can be overly pessimistic at others. Your job is to do your homework, know the value of the stocks you own, and then let Mr. Market serve you by providing you with bargain purchase prices and/or exorbitant sale prices.

We Are Mr. Market

One thing to keep in mind in all of this is that Mr. Market is basically the hive mind of all investors in aggregate. Mr. Market represents the "wisdom of the crowd" that we investors are all participating in. In other words, we are Mr. Market. So in the mental checklist you use for each contemplated purchase or sale in the stock market, make sure that you incorporate some form of the question, "Who is being crazy here—me or Mr. Market?"