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This cartoon drawing (author unknown) is, in my opinion, an excellent representation of how traders (and thus markets) irrationally react to news and events over the short-term. What is even more surprising to me is that most people view the **results** of their crazy behavior (marked changes in stock market prices over short timeframes) as **justification** for their initial irrational behavior. This cartoon could easily represent "The crazy old men" Sandy Smith observes in the following story.

The following story is a metaphor to illustrate how people react (and overreact) to current news and events. In this publication I shall try to provide a basis for my readers to observe the phenomenon of market reaction and overreaction (and its affect on market pricing) by using a fictional story about a city called Stockville. The concepts I am trying to illustrate are important and are especially relevant today. Please take five minutes to read and consider the following story. I believe many of you will find it enlightening and helpful.

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The Smith Children of Stockville

Stockville is a city identical in almost every respect to any modern American city or town. The people dress the same, have the same jobs, and speak and act the same as you and I. The only difference is that in Stockville *everything* can be traded as if it were a stock. The "stocks" trade at the local public market. Alongside fresh local meat and produce, traders make markets in services, homes, cars, and even the smallest of businesses. Even a child's lemonade stand can be readily bought or sold in Stockville's market. In fact the standard lemonade stand trades in Stockville under the symbol "LS"! And that is where our story begins.

Sandy, one of Stockville's industrious 9 year-olds, partnered with her sister a few years ago to start a lemonade business. Sandy and Ann successfully ran the stand for 3 years and made $100 per year. One day a passerby asked the girls what they would be willing to sell their business for. Sandy (not yet knowing anything about the stock market for lemonade stands) thought about it a bit, did a few calculations, and then responded that she thought a fair value for her business was $300. The stranger guided his finger along a table of numbers in his newspaper and shook his head and replied "I would have given you $350 yesterday, but can only give you $250 today," and moved on. The girls found this behavior to be very strange and asked their mother about it[1]. That was when Mrs. Smith decided to introduce the girls to the local market.

So one day Sandy went with her mom to the local market. Sandy was fascinated with the stock traders and quickly went over to the LS trading pit and noticed market makers were willing to pay her $250 for her LS. Sandy smiled and politely said "no thank you" to a frantic (almost manic-looking old man). Sandy was confident her LS was worth $300. Sandy thought to herself that clearly this market and the people trading in it were crazy and she wouldn't ever consider selling for such a low price. Sandy and Ann laughed as they watched the comical crazy old men in suits screaming at each other making furious trades while watching a screen showing the movement of "LS". How possibly could the value of her lemonade stand meaningfully change in the course of a few minutes? Sandy was sure when she went home the lemonade stand would look and perform exactly the same as when she left that morning. Therefore Sandy didn't return for a couple of years, after the young entrepreneurs had saved enough money to potentially try to buy another lemonade stand. They hoped they could still get one of the quirky old-timers to sell them one for only $250.

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[1] Note that a person's *natural* instinct when asked what something is worth is to come up with a value based on their knowledge of the item (in this case earnings of the business). When the stock market is introduced many people allow the *market* to dictate their perception of value.

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The Great Lemon Famine of 2009

When Sandy finally returned to the market it was at a time of high lemon prices. The crop had failed in Florida and lemonade stands would likely have sharply lower profits! The traders looked despondent and were offering to buy and sell LS for only $150. Sandy thought the traders were being even sillier than a couple of years ago: $150 was way too cheap even if lemon prices stayed high (and she was pretty confident they wouldn't stay high forever). She thought she would only make $50 less that year before things would normalize – so how could that make her lemonade stand worth $150 less? Thus Sandy spoke with Ann and they reasoned it made sense to buy another LS together (representing an identical lemonade stand down the street). Sandy felt confident she was on her way to making more money and this time became enamored with the stock market[2]. She decided to go back every day and look for more bargains.

Sandy Gets Greedy

Over the next month Sandy became more excited as she watched frantic LS traders increase their offers for LS from $150 up to $500. She thought it was funny how a month earlier the traders were jumping over each other to sell the same LS at $150 they were now scrambling to buy for $500. But now Sandy was watching the market and had an opportunity to sell her LS shares for $500 her views started to change.

Before learning of the stock market Sandy would have happily sold for $300. But it appeared the crazy men in the trading pit were increasing their offers almost daily and the world on the street was that everything in the world was fantastic and therefore stocks would go up much more. Therefore Sandy decided to wait until the traders offered her $1,000! The market looked so good that one boy on her street even quit delivering newspapers to hang out at the market all day to trade LS. Everyone in her neighborhood thought he was a genius (and not that he was becoming one of the crazy old men). The boy would buy LS "on a dip" and then quickly sell LS to another trader for a quick profit! Both Sandy and Ann felt fortunate to own *two* LS and they were excited if traders kept offering more for LS as quickly as they had in the past year that in a short while they would be rich! Ann even asked if they should try to buy another LS at $500 to make even more money, but they hadn't saved enough yet to consider it.

Ann Panics, Sandy Refocuses on her Business

However the next day panic gripped the LS market. A newly elected government official in Hungary mentioned the past government administration was more fiscally irresponsible than even they believed during the campaign when they made campaign

[2] Note that Sandy calculated when she *bought* the stock it was a good investment without initial concern to what the "crazy old men" would offer to buy it from her the next day. The value of the *stock* was trading independently from her perceived value of the *business*. Sandy was not anticipating quickly selling it at a profit, she was thinking about the expected cash the business would generate over time.

promises they would now have to renege on. That speech led the traders to be concerned that Hungary could eventually default on some public debt and fear gripped all of the world markets – even in the LS market in far-away Stockville! That day when Sandy went to market the traders only offered $150 for LS! When she returned the next day the traders offered $100. Then the following day the traders (looking pathetically depressed) only offered her $75. The panicked traders and many people on the street were saying the world was going to end and everyone would be poor – stocks wouldn't return to higher prices for many, many years. Sandy's sister Ann became very upset at Sandy for talking her into buying another LS. Sandy tried to explain that even if dire things happen over the next couple of years she believed they can make at least $50 per year from each LS and then when things get better up to $150 a year. It didn't make sense to sell LS because the cash they could reasonably expect to generate from the business was more than they were being offered. But Ann simply saw the ticker "LS" going down each day and decided to take her share and sell it. She used $50 of the money to buy a lump of metal that an expert (one of the people they once thought of as a "crazy old man") told her would be worth far more than LS over time even though it couldn't earn any money or do anything. She paid the same expert $5 to help her sell her LS and $10 to get her the lump of metal. She then paid $5 per year to a company the expert suggested she use to place the metal in a secure vault so no one could steal it.

Over the next few days Sandy despaired as the traders offers dwindled to $50. She thought about selling before it was too late but decided instead to focus on running her lemonade stand. At that point many of Sandy's competitors "threw in the towel" and sold their shares -- oddly to the companies employing the mad traders. Neither Sandy nor Ann returned to the market until several years later, when Sandy was ready to sell her stand to help pay the tuition for a school for child prodigies.

Just as Sandy had predicted she made an average of $100 per year from her lemonade business ($50 the first difficult year, followed by years of making $100 and $150). And when a trader at the market offered her $300 for her LS she happily accepted it as a fair value.

<u>Ann is Broke and Unhappy; Sandy is Successful and is Unhappy</u>

When Sandy went to the bank to deposit her money the teller told her a story about a customer who had bought LS at $50 a few years prior and recently sold it for $1000 (LS traded for $1000 for less than a day before crashing back to $300). Sally is not happy as she now believes she both bought and sold "at the wrong time" and therefore missed out on making a fortune.

Today Ann is not happy because she lost money when she sold her LS share – and now she doesn't even have a lemonade stand to bring her $100 annual income. Today Ann is working for pennies at the old lemonade stand she sold to the trading company for $75 as it bring in $100 per year for her new boss. Of course Ann is still paying that same company $5 per year to protect the lump of metal they sold to her.

What did Sandy and Ann do right and what did they do wrong? How should they react to the next market event? Are the crazy old men (traders) insane or should we give them our money to buy and sell over short time periods to try to get rich quick?

The "Moral of the Story"

- The stock market is *irrational* over short periods of times. We must invest for the long-term and not look to the market to immediately validate what we have calculated. Warren Buffet states "over the short term the stock market is a popularity contest; over the long term it is a weighing machine." I couldn't agree more.
- Sandy was rational in her decision to buy LS at $150 per share, even though the market for LS went down to only $50 per share. Sandy neither could have known about the speech in Hungary nor could she have known the market would have reacted so irrationally. She was wise to not to join the market traders in their crazy panic and sell at $50. Note that Ann emotionally sold her share (and essentially fired Sandy as her advisor) and hired one of the "crazy old men" her and her sister originally laughed at to "professionally" manage her money.
- Invest rationally based on calculated research and then focus on what you do best. Work your job and have fun with your family. Leave the craziness to the markets!
- Avoid looking back at what "could have happened." Not only can you become discontent with your relative success and prosperity, but the more you watch the news and ticker symbols the more likely you are to join the crazy old men and lose both money and emotional well being.

- News must be taken in context of the companies we invest in and usually news is a short-term market phenomenon. Even wars and major crises generally have little long-term effect on market prices (please see the chart at the end of this newsletter).
- Make sound and logical decisions and only invest in something you wouldn't mind holding for many years. Look to the stock market as a means of making money *over time* by owning successful *companies* and not to get rich quickly by playing a game of hot potato with crazy people using *stock ticker symbols*.

- If you do these things then over time you are likely to do well both financially *and* emotionally.

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Brief Commentary on Europe and Other Crises

The recent events in Europe certainly can and will affect many of the companies we have invested in – and they may even affect Sandy's lemonade stand to an extent. But long-term it is likely the economy will mend and out companies – and the lemonade stand – will be profitable.

We have no way of telling when disasters will strike and to what an extent they will have on the *long-term* viability of the companies we own part of. We also don't know when random fortunate acts shall happen (i.e. Sandy's competitors wiped out in a storm), but things tend to normalize over time. If you spend your days trying to guess what the next disaster or mania will be you will go crazy and probably not make a dime.

If you consider the stocks we are investing in to be *companies* (lemonade stands) and not ticker symbols (LS) you will rest better at night, not worry as much about the daily stock price movement, and probably make more money over time. Just because someone offers you $50 for a lemonade stand that makes $100 per year doesn't mean you have to agree with them; you don't have to sell it. Just patiently wait and let the earnings come to you over time.

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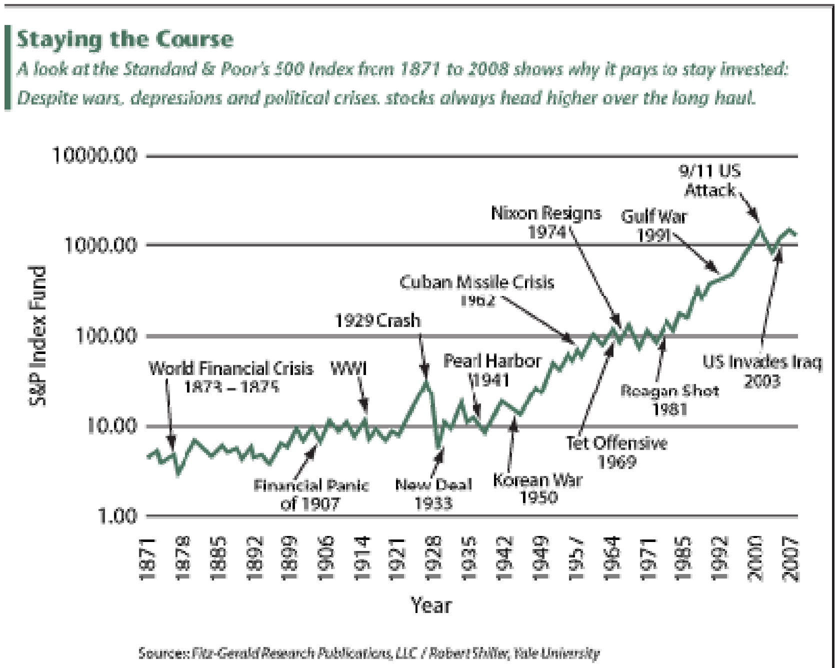

Try to place yourself back at the time of each of the disasters noted in the graph above. How would/did you then feel about the stock markets and the state and safety of the world economy? How does the current economic challenges compare with the prospect of World War I, The bombing of Pearl Harbor in 1941 (and the rest of World War II), The prospect of nuclear war in 1962 or in the 1980s, A potential war with China during the Vietnamese and Korean conflicts?

Source: http://www.straightstocks.com/stock-watch/the-only-stock-market-chart-investors-need-to-see/ [i]

We have logical reasons for investing in each of the companies we own shares in. The markets valuations may fluctuate wildly from day to day, however over time it is likely most of our companies shall earn profits and this will eventually translate to higher net valuations. This has historically been the case through multiple crises of apparently larger scale than we are facing today. We will continue to invest logically and not try to guess how the crazy old men will react to the next shred of data that will soon become yesterday's news. We are investors, not psychics.

Best Regards,

Mark Elliott, President
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Mark Daniel Elliott, LLC, a Registered Investment Advisor.

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[i] This graph was also used in our October 2008 Newsletter. The author's comment "Stocks 'always' head higher over the long haul" is that of the original publisher of the graph. Even though we believe stock market prices are still attractive we are not and will not make such representations.