

# Econ 101

BY BRIAN BRUCE

## The Whims of Wall Street

Too often, investor sentiment determines a company's success more than sound fundamentals. Welcome to **behavioral finance**.



**I**F YOU'RE ANYTHING LIKE T. J. "SKIP" FALGOUT, III, Dallas-based chairman and CEO of America's Car-Mart (NASDAQ - CRMT), last year left you scratching your head trying to figure out what happened to your stock price. After reporting an earnings-per-share increase from \$1.31 to \$1.49 during 2005, Car-Mart's stock fell from \$25 to a low of \$15 for the year. The company's numbers were golden. So where was the love from Wall Street? In 2005, Falgout, along with a number of leaders of publicly traded companies throughout the United States, were victims of that perennial board room boogeyman: investor sentiment.

"We find that perception does outweigh reality in determining our stock price," Falgout says. "At times our stock is affected more by investors' perception of our customers than our financials."

Take Dallas-based Belo (NYSE - BLC). In 2004, the company's revenues and earnings increased, but during 2005 the stock price fell from around \$26 to below \$22. This despite the fact that Belo had solid financials and beat analysts' expectations in the first three quarters of the year.

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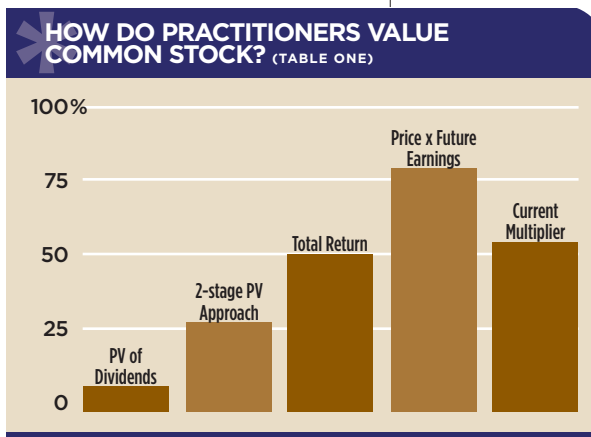
### »THE TAKEAWAY

- 1 Bad things happen to good stocks.
- 2 "Fair value" approximates stock price—if you're lucky.
- 3 Money managers overreact.

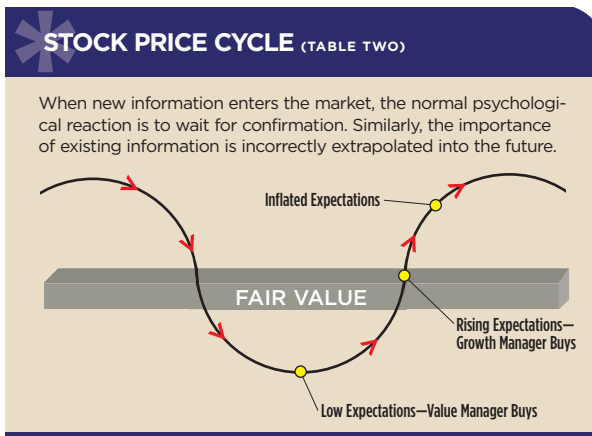
market is nothing new, but the tools to analyze it are. After years of ignoring the facts that people have to invest in stocks for them to have any value and that people don't always process information correctly or act rationally, academia has finally started to study behavioral finance and understand its effects. Simply stated, behavioral finance advocates that the price of a stock moves around its "fair value" as a result of irrational factors such as investor emotion. Investors calculate a firm's fair value a number of ways, the most popular of which uses discounted future earnings, discounted future cash flows, and earnings multiples. But regardless of what the cold, hard financial data would suggest, investors are sometimes pessimistic about a firm, and at times they are optimistic. This leads to deviations from fair value.

Of course, it hasn't always been this way.

For many years, analysts and investors were guided purely by the numbers, applying formulas to data gleaned from a company's income statement and balance sheet. One of the most widely taught theories is the dividend discount model



SOURCE: DUKES, PENG AND ENGLISH 2005



(DDM). This model assumes that a stock is worth the sum of a company's future cash flows, as cash flows are how an investor gets return on his or her investment.

A recent academic study, however, shows only 25 percent of firms today use any version of the DDM.

You can see from Table One that the most commonly used metric is price divided by future expected earnings, also known as the price-to-earnings (P2E) ratio. This approach is considered a relative valuation method for valuing a stock. It also uses a firm's financial data to determine the proper value for a firm. But formulas such as DDM or P2E ultimately prove insufficient in explaining the movement of stock prices. A CEO who tries to get his company's stock to trade at the price the fundamentals would suggest is going to quickly tire of pushing that rock up the hill. The best he or she can hope for is to minimize variance from fair value.

One of my favorite articles from *The Journal of Behavioral Finance* (which I edit) was an article in 2000 written by Eric Lukin and famed value investor and *Forbes* columnist David Dreman titled "Investor Overreaction." Looking at the period from 1973 to 1998, their research revealed that even when company fundamentals like profit margins and return on equity remained stable (varying by only a percent or two), prices varied by as much as 15 percent a year.

Table Two shows the typical cycle that most stocks follow. Beginning at the left of the chart, the price starts to fall below fair value. This happens to almost every com-

pany at some point. Your market share shrinks. Your margins fall. You are no longer the high flyer, and market sentiment for your company cools off. As investors realize you can't get 100 percent market share (something you would have achieved if the long-term growth rate that investors expected of your company had continued long enough), the resulting negative sentiment causes

the price to fall below fair value.

Once your stock price has fallen below fair value due to negative sentiment, simply fixing your firm's fundamental financials won't cause the stock price to turn around. This is key to understanding the effect of behavior on stock prices. Prices don't rebound until positive new information about your company is disseminated across the marketplace. Once good news infiltrates the minds of investors, the price of your stock will start to rise.

Stock prices ascend because investors herd, and in doing so they overreact—in droves—to information. During the technology bubble several years ago, in meeting after meeting with pension plan representatives, I was asked, "Why don't you own Cisco? Everyone else who has come in to talk to us owns Cisco." Money managers don't like to answer questions like that. They tend to buy stocks that brokers are touting and are popular with other managers. Money managers also overreact. Once a company's good news has gotten into the marketplace and caused the stock to rise, it's difficult to figure out how long the good news will last. And trust me, money managers always think it will last longer than it does. This causes the stock price to become too high. Expectations are too high. At some point, they will start to fall, and the cycle will start all over again.

So half the solution lies in always understanding where your stock price is relative

to its fair valuation. The other half lies in figuring out how to get investors enthused at the bottom of the cycle and how to temper their enthusiasm at the top. Several courses of action here are recommended:

**1 Hire a consultant** or put someone on your board of directors who understands behavioral finance and can complement your in-house investor relations (IR) staff. This person can work with your IR team to:

- *Analyze the behavioral impact on financial data before it goes to analysts.*
- *Review financial statements before they are made public.*
- *Help guide the dissemination of financial information to the media and investment communities.*

**2 Be sure to meet with industry and security analysts** at least four times a year to keep them apprised of your activities.

**3 Communicate with shareholders via conference call or web cast** when you are at the top and bottom of cycles to moderate their exuberance or assuage their doubt.

**4 Launch a monthly market commentary on your web site** to help your investors understand what's going on in the market.

The best-laid plans can't control the movement of your company's stock price all the time. However, careful plan-

ning and credible, timely communications with analysts and investors—in good times and bad—can help smooth out the fluctuations and ease your stress and uncertainty caused by that most fickle of creatures: investor sentiment. **D**

**EDITOR'S NOTE:** Brian Bruce is a finance professor and director of the Portfolio Practicum at the Cox School of Business at Southern Methodist University. He has overseen the investment of multibillion dollar portfolios for leading money management firms, including The Northern Trust Company, State Street Global Advisors, and currently for Putnam Investments subsidiary PanAgora Asset Management.

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