Stock Market: Voting vs. Weighing Machine

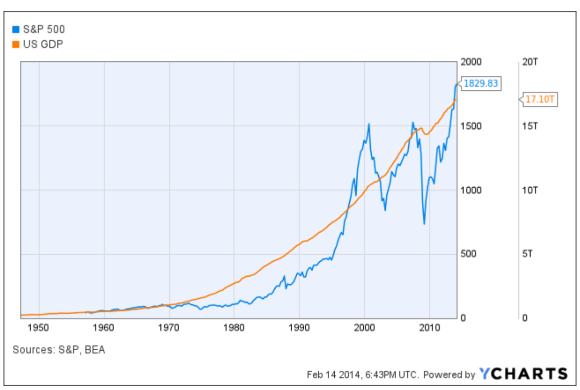
Perhaps you've heard the phrase "short-term, the stock market is like a voting machine, but long-term it acts like a weighing machine" -- a quote attributed to legendary value investor Benjamin Graham. But what does that mean and how does it apply to your investment portfolio?

The quote basically means that the short-term movements of the markets tend to be based on subjective or emotional judgments, rather than any actual change in the value of the securities being traded. In fact, you can be amused when economic pundits say that the markets went up one day because of a positive government economic report, and then a few days later they will say the markets went down because the government's positive outlook might mean that the Fed will taper faster than planned. It is not uncommon for the same type of event to be blamed for a market decline and cited in a market rise within days of each other.

Longer-term, however, the quote suggests markets are driven by something different: gradual changes in the underlying value of the securities being traded. Over time, as a company's business expands -- growing its sales and earnings -- it becomes more valuable. None of this shows up in today's trading, but over the years, the rise in value becomes visible.

One of the valuable lessons in the quote is that it is better for your financial well-being to ignore short-term events and focus on more durable longer-term trends. Another, is when you buy a stock or basket of stocks, you are participating in the growth of the underlying businesses and the economy as a whole. That means that when millions of workers toil away at the office for days and weeks on end, creating value, building enterprises, coming up with new ideas, building and making and creating, you are also participating in the fruits of their labor. The effect is gradual, but clearly visible if you can look at the longer-term impact on your investments.

The graph below shows the growth of the U.S. economy since 1950 (orange line), from less than $1 trillion in economic activity to more than $17 trillion today. American workers, in aggregate, appear to have worked wonders in terms of total value creation.



Also shown is the rise in value of the U.S. stock market as measured by the S&P 500 index. You can clearly see that, while economic activity seems to "plod along", the stock market has more intense movements – sometimes growing more slowly, sometimes quicker.

But overall, the stock market seems to return to the growth pattern as the economy as a whole. This is the "weighing machine" aspect of the markets -- the fact that people eventually notice whenever the markets are priced higher (lower) than underlying economic value. While it can take years, real value eventually asserts itself over short-term emotional responses.

The graph doesn't tell us whether stocks are overvalued or undervalued today; nor, really, will anything or anybody tell us that with any certainty. The important thing to focus on is the growth. That's why we invest; to capture that long-term growth. The tradeoff is to accept some setbacks along the way -- when the voting machine can't see past the short-term dangers – for the longer-term opportunities.

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