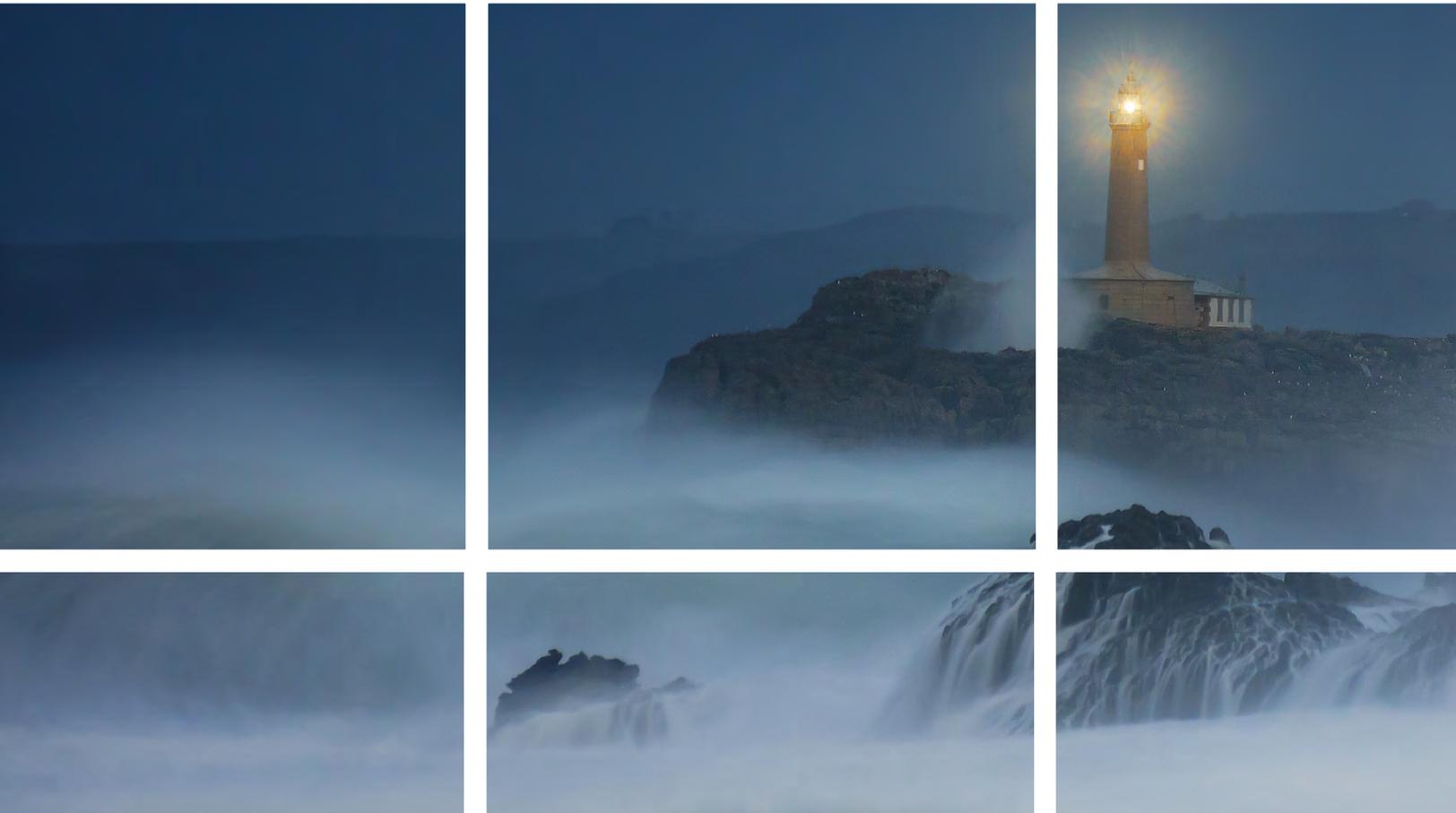


MR. MARKET

The nature of the stock market
and what it means for our investments



MR. MARKET

In 1949, Benjamin Graham introduced Mr. Market – a revolutionary way to view the stock market. To this day, Graham’s Mr. Market analogy is often used to explain the market’s tendencies to fluctuate.

WHO IS MR. MARKET?

Imagine Mr. Market is your business partner. Your partner is manic-depressive who frequently offers to sell his share of the business or to buy your share. His estimate of the business’s value fluctuates from very pessimistic to wildly optimistic. You are free to decline or accept his offer knowing that he will soon be back with a different one.

A rational person would buy shares in a business if the price is low and sell if the price is high. Furthermore, the decision to buy or sell requires that the person know the value of the business they own.

He or she would not buy a business just because the price went down and conversely would not sell simply because the price went up.

Understanding the value of that business allows the person to recognize a good offer from Mr. Market and avoid a bad one.

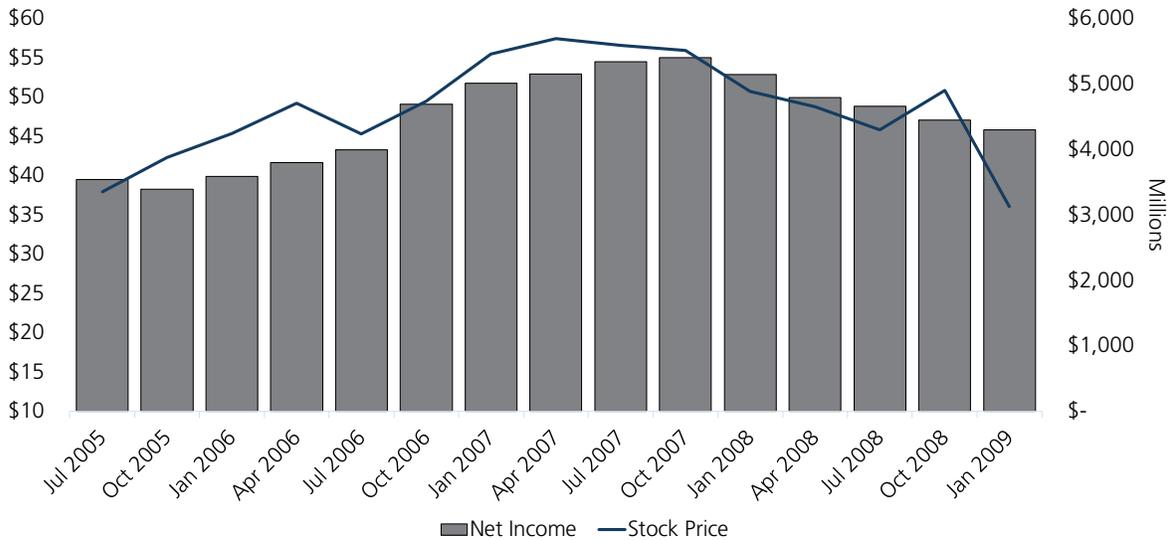
Certain types of businesses lend themselves nicely to the valuation process. These businesses are understandable and durable by nature. They are difficult to live without, difficult to replicate and difficult to compete with. The businesses that are more challenging to value are those where the future earnings are less predictable or could be permanently impaired. Some might say that investing in these types of unpredictable and unstable businesses is not investing at all; rather it is a form of speculation.

Let’s take a look at an example of what happened to a very durable business during the 2008-2009 financial crisis...



Leading up to the crisis, the Royal Bank of Canada's (RBC) share price reached a peak of \$60 per share. This is a very reasonable price (14x earnings) for a world class business. When the crisis hit, the stock price took a nose dive to \$26. Earnings per share dropped to \$2.44 making it an even more attractive opportunity for buyers.

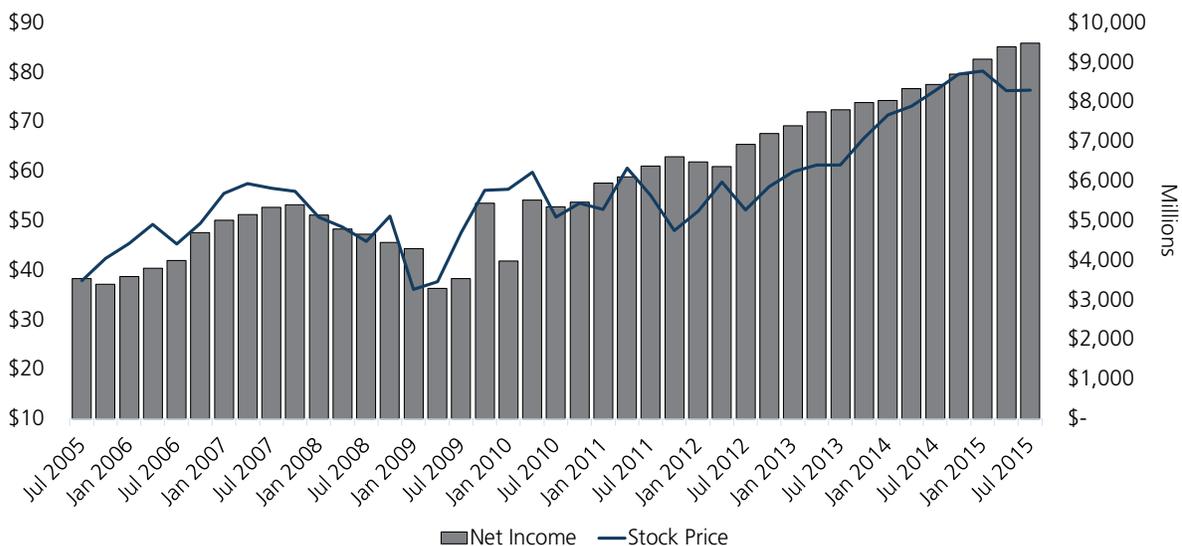
RBC'S EARNINGS & STOCK PRICE (from July 31, 2005 to January 31, 2009)



Source: S&P Capital IQ. All figures in CDN \$ unless otherwise indicated.

As of July 31, 2015, RBC's shares were valued at \$76 earning \$6.56 per share.

RBC'S EARNINGS & STOCK PRICE (from July 31, 2005 to July 31, 2015)



Source: S&P Capital IQ. All figures in CDN \$ unless otherwise indicated.

KEY POINTS

- 1** Own durable businesses - if you are not confident about a business' durability then sell it.
- 2** Know the value of what you own.
- 3** Buying RBC at \$26 while earning \$6.56 today is a 25.17% earnings yield (also known as a homerun!)

If you own durable assets and you know their value, you can take advantage of Mr. Market, otherwise Mr. Market will most certainly take advantage of you.

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