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Capital market's answer to the greatest question of them all: Doo dam doo da, di doo dam dam

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"This past year did not go as planned," wrote Bruce Berkowitz earlier this year. "Although markets reached new highs in 2017, there was not much to celebrate as the securities of Sears wrecked the funds'performance. Sears realized billions of dollars from asset sales, as we predicted, but I did not foresee the operating losses that have significantly reduced values. Getting the asset values largely correct, but missing the company's inability to stop retailing losses, has been hugely frustrating and fatiguing for me to watch."

Fund managers often write apologies. They explain to their audience of readers why they are right and why Mr. Market is (temporarily) wrong and that patience is a virtue. Too often they provide a narrative of the set of circumstances that should occur in the future. And too often they are dead wrong. These reports are typically dispatched when Mr. Market works against the fund managers. Read: when the stock price is down.

So while fund managers often write when the stock price, in this meditation I take the opposite approach. That is, I write when the stock price up. The irrationality of the Voting Machine (i.e. capital markets) is our topic at hand. And the company at issue is ARC Document Solutions, a reprographics firm.

In A Fair Company at a Wonderful Price I wrote about my purchase of ARC. For the okay-but-get-to-the-point reader: I bought 12,000 shares at an average cost of $2.15. What I saw then in ARC was a bargain stock: a low earnings per share multiple and a 2017 income statement that did not reflect the true intrinsic earnings power of the business. (One example is that the company booked a $16 million expense related to goodwill impairment, a non-cash expense.)

But the Voting Machine did not see it that way. After I bought the stock, ARC dropped to record lows for six months. In numbers: the stock of ARC started 2018 at $2.50, reached a high of $2.59 and in July 13 of this year investors were able to purchase the stock as low as $1.64 - I associated the drop in price because Russell 2000 dropped ARC from its list of stocks. And this loss in the popularity contest scared the Voting Machine.

Yet, as I type these words, the stock is trading hands at $2.90, 35% higher than the price I paid for the stock 6 months ago.

A senseless uptick in value

Two things pushed the stock price. First, on July 16 management dispatched a press release where it foretold investors that for the first time in three years, it will report a growth in sales in the next quarter.

And management did not fail on its promise. On August 3 of this year, management reported that revenue increased from $102.3 million to $104.2 million; that earnings per share were up from $3.7 to $4.1; and that debt obligations declined from $152 million to $136.2 million.

Overall it was less than a 3% improvement in operations, but the Voting Machine was irrationally exuberant nonetheless. Zacks, a stock research website, posted a bullish article titled Here's Why You Should Invest in ARC Document (ARC) Stock. And in Is It The Right Time to Buy ARC Document Solutions? Jodi Pearce of Simply Wall Street, recommended a buy.

But the improved quarterly results did not give grounds for the uptick in value. The company is still heavily dependent on the construction sector, a cyclical sector with much volatility. And it was reported that the reprographics industry is shrinking and that competitors continue to steal market share from the ARC.

Can you see such a difference between perceived value and reported results in the world? Say you own a condominium rental and are able to increase the rent to your tenants by 5%, from $2,250 to $2,362 (this is how much I pay in rent for a two-room-one-bathroom apartment in San Diego). With the new, increased rent, can you think of a scenario that you would be able to sell the rental apartment for 50% more than what comparable sales were less than six months ago? In San Diego numbers, for a condo that sold for half a million in June 2018, you would list for $750,000.

The Voting Machine finds reasons for value in other places than the reported financial statements. The Voting Machine decides, based on growth expectations, whether a company is winning a popularity contest by Wall Street analysts. And there are other psychological factors such as investors who are now buying ARC simply because they believe and hope that other investors will buy ARC from them at a higher price.

What is also clear from the case of ARC is that the price from which the stock traded hands offers little insight to the true value of the stock. Dear readers who believe in the efficient market thery, please reflect how a company can value increase by more than half in less than two months when the economic fundamentals of the both the company and the industry have not materially changed.

And if a company's stock price does not serve as guidance to intrinsic value, and if the Voting Machine simply does not care about the fundamental textbook accounting standards, where should we look for guidance on value? Leonard Cohen, the late Canadian folk singer-songwriter perhaps had the right answer. “Would like to know the true meaning of things?” he once asked in a live concert I attended. And as the crowd cheered and applauded for the ultimate answer to the greatest question of all, Cohen hummed back: “the answer, the true answer to the deep mystery is: doo dam doo dda di doo dam.”