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Can value investors learn something from *Narrative Economics*?

by Paul Varotsis

You may have heard of Robert Shiller's recent book *Narrative economics*. Shiller is 2013 joint economics Nobel Prize winner and Yale professor, famous for his 2000 book *Irrational Exuberance* and his 2009 book *Animal Spirits: How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism,* he is also co-creator of the Case Shiller Home Price Index.

In this book he looks at how narratives (stories) may have an important influence on economic activity despite being generally ignored by the economic profession. This book is typical for Shiller, a timely reminder, in the era of social networks and twitting presidents the way the economic activity is framed constitutes an important dimension of what the public perceives is happening and as a result may be a factor in their actions, whether it is postponing purchases or who to blame for a recession.

1. What does Shiller say?

We have all heard the story of Joseph Kennedy, or was it John D. Rockefeller, who after receiving stock market advice from his shoeshine boy went back to his office, sold all his equities and went short on the eve of the 1929 market crash. It is part of the market's mythology and same as Greek mythology it is not fact as far as Shiller could gather, but still quoted and repeated. So, his point is that stories matter in people's understanding of the world and the actions they take as a consequence.

Shiller looks at narrative economics (as what I see a narrow perspective) in their impact on economics. He shows that narratives have been and continue to behave quantitatively like epidemics following a bell-shaped normal curve of contagion and recovery.

He makes the point that stories do not need to be true or accurate but need to go viral to have an impact. The behaviour provoked by stories is not consistent through time and depends on the spread of the stories.

He takes example of economic narratives like labour saving machines first mentioned in antiquity and developed in the 19th century, these had impacts

on people behaviours and government policy taking the guise of AI, driverless cars and UBI today. Other examples include business confidence, consumer confidence, Bitcoin, the Laffer curve

But what makes a story go viral?

- They must be short, catchy and as a result caricaturing reality.
- A celebrity or super spreader help infect many more people.
- They are part of a narrative cluster; newer narratives are mutations of older ones.
- They often have a moral dimension.

Shiller does mention how narratives shape our perception of stock market levels and are involved in booms and busts and what motivates investors' views.

But maybe we can go one step further and question whether stories shape the value of a company and how investors determine what the fair value is.

2. <u>Could this have a relevance for value investing, and if yes how?</u>

Fair value is a contentious concept for in order to determine it, we need to establish a series of future cashflows that are as likely to occur as any other kind of investment prediction. Buffett famously mentioned the example of a motorway as an example of a good predictable business, but we all know that most businesses are not that predictable, even motorways (Atlantia SpA).

Companies come with stories, and celebrities, Apple and Steve Jobs, JPMorgan and Jamie Dimon, GE and Jack Welch and they often have a strong moral dimension, just look at the impact of Zuckerberg's perception on the value of Facebook. [The example of Jack Welch is particularly interesting in my view as the legend of Jack Welch survived over a decade the reality of GE's business' troubles, it was kept alive by his successors despite many difficult encounters with reality.]

At the point of purchase narratives are an important dimension in order to determine the future cashflows of a business. When we purchase what we consider under-priced shares, we must have a different narrative from the one determined by the market. Take the example of Tesla the market may decide that the company will not make it past next year because they'll run out of cash, but some investor may view future cash flows as likely as they may expect sales to be higher. I don't judge here the merits of either narrative or of Tesla as an investment, just the fact that narratives of the market and the investor <u>must</u> be different for the value investor to be able to purchase the shares cheaply.

For a value investor it is also important in order to realise value from their investment. If an investor decides to purchase a particular company's shares that the investor's narrative differs from the narrative as perceived by the market.

However, in order to realise the value in the future the market narrative needs to change, and this will hopefully be achieved by better than expected results.

But and this is an important point, the investor may achieve a better price NOT from better bottom-line, but from a changed narrative in the market. Apple is a recent example of a change in narrative, if their results have been marginally better than expected over the last year they do not justify a doubling of the share price that in my view results from a change in the narrative.

In *Poor Charlie's Almanac* Charlie Munger refers to have "multiple mental models" approach to business assessment and analysis and he suggests a few like looking at a business like an animal in its complex ecosystem and applying evolutionary biology mental models
In my view narrative economics offers us a different model of what is being said, watched and exchanged and how this may impact our estimate of value. We may like to think of ourselves as ivory tower investors, but I know I am not, and my perception of value is heavily influenced by the stories I read and listen to. So being more aware of how these influence our views may help us make more sensible choices.