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**Investment Strategy: All About the Benjamins**
**Bernanke vs. Graham: In whom do you trust?**

By MARK SPITZNAGEL

Two disparate views of markets represent well the range of opinion among U.S. stock market participants today. One is a devout faith in market efficiency and the supremacy of market pricing as a reflection and forecast of fundamental value. The other expects errors and biases in market pricing.

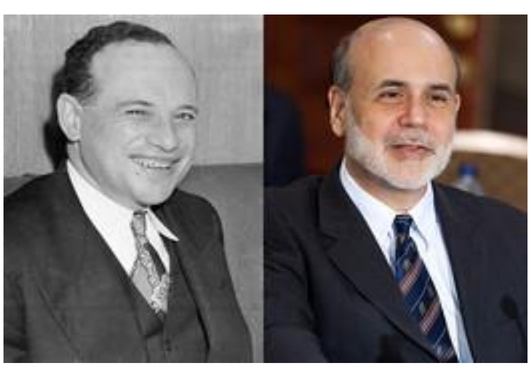
The first should be recognizable as belonging to Ben Bernanke (easily the biggest trader and most significant market manipulator in history); the other to Ben Graham, the father of value investing. With which Benjamin do you agree?

I think a simple thought experiment best answers this question. Imagine a world where the stock market is open for trading only one hour of every year. No more scrolling stock tickers or central bank scuttlebutt on interest rate policy (and certainly far fewer insufferable hedge fund managers and Wall Street traders).

If this would change how you invest, then apparently a steady stream of market quotations is a sine qua non of your investment process; a trade makes sense to you when validated and quickly rewarded by the constant transactional opinions of your friends in the marketplace. You are a Benjamin Bernanke trader.

However, if you would maintain the same investment approach as always, then your investment decisions must be based on your expectation of the cash flows to be received from those investments, irrespective of what subsequent market quotations have to say about them. You don't care what your friends think (and you probably don't have many of them anyway). You are a Benjamin Graham investor.

To the Bernanke trader, market prices are the most information-laden depiction and forecast of the state of the world. They are neither dear nor cheap—they just are. Thus statements such as "price increases largely reflect strong economic fundamentals" (Mr. Bernanke's take on house prices in 2005).



The two Benjamins: Graham, left, and Bernanke.

But the wisdom of the crowd turns tragically biased when opinions are interdependent. And amplification and contagion of opinion is what markets do so well through continuous Bernanke trader herding. The Graham investors recognize this, as well as the difficulty for anyone—especially economists and analysts—to accurately predict changes in macro variables or returns on corporate investment. They treat the implicit forecasts embedded in market valuations as folly. Markets get dear and cheap, and it's pretty obvious when they do.

Clearly, lower interest rates can promote greater purchases of risky assets and thus higher stock market valuations, as market participants assume a more flush economy and willingly accept more risk to generate a respectable return. Bernanke traders do often rule the roost—and for years.

Today's stock market is a case in point. Bernanke and his traders are stampeding, as rising stock prices signal higher corporate returns and earnings to come. Among their rallying cries is the expectation that stock price volatility, when positive, will magically and recursively improve the very fundamentals being priced (the "wealth effect"). Meanwhile, Graham investors have stoically stepped aside.

History does not bode well for the Bernanke traders. Interest rate levels and stock market valuations imply forecasts of economic activity and returns that don't pan out. Low interest rates give only an ephemeral boost to stock prices and, like clockwork, are always accompanied by higher liquidity preference (or holding of cash relative to GDP). So, as today, central-bank decreed low rates don't work.

The Q ratio is the aggregate stock market valuation relative to net asset replacement cost, which accurately gauges the market's expectations of returns on tangible capital and resulting profit growth. That ratio has made a half-dozen historic highs since 1900, all of which were followed eventually by much lower stock market prices. This ratio very recently surpassed all of these highs except for the go-go late 1990s. Moreover, corporate returns on invested capital have been volatile but have otherwise remained flat, enforced by a very competitive economy.

It can always be different this time. Black swans abound. But there is a distinct difference in the consequences of failure of these two investment views. The Bernanke trader takes positions at prices often implying extremely advantageous and precise scenarios, the adjustment of which would mean severe losses. The Graham investor takes positions only at prices implying exceedingly disadvantageous scenarios, the adjustment of which would, by definition, mean far less severe losses. While the Bernanke traders bask in the market's efficiency, the Graham investors dither in their margin of safety.

So with which Benjamin are you betting? Certainly your answer to this question ought to be the same Benjamin with which you agree. But there are plenty of cognitive biases that may prevent us from betting our beliefs. And the vast professional investing community may not have the luxury of choice, as the career risk associated with exclusion from the Bernanke trader camp can be the stuff of nightmares. The only thing certain? One Ben's views will win.

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