FINC3015 Financial Valuation: Case Study Approach

What is value?

Adam Smith first noted ambiguity surrounding the word ‘value’, which can mean **usefulness** in one sense and **purchasing power** in another.

In finance, value is a derived result based on three factors:

- expected cash flows
- growth
- opportunity cost and risk

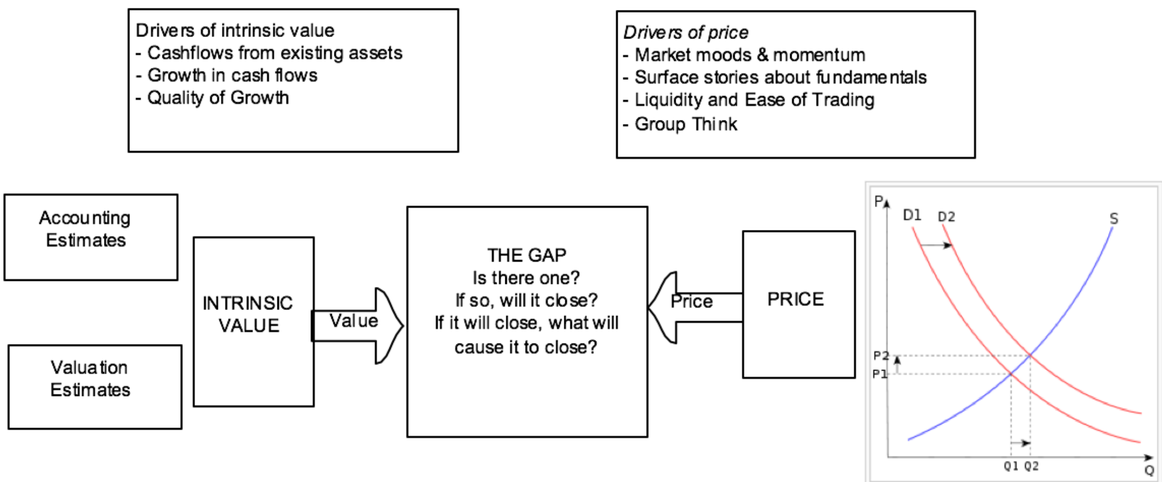
Price is a quantification of value that takes place in an ‘open market’ situation i.e. based on supply and Demand

The uncertainty of these previous factors (which takes place in the background) in addition to other effects (i.e. investor behaviour such mood and momentum) can lead to large distortions between price and value.

This is because in financial markets, we rely on the market to price value – at each point in time, we get a snapshot estimate of *exchange value*.

- If markets are efficient, then price is a reflection of underlying value.
- However, market efficiency is drive by the type of asset being traded, type of market the asset trades in, scarcity of the asset, type of traders in the market etc.
- Therefore, the distortion between price and value can continue well into the long-term.

“Price is what you pay, value is what you get” – Warren Buffet



Example – Keynes's beauty contest.

Keynes ("The Beauty Contest")

- Say you entered a contest (free to play) where you were asked to pick the 5 most beautiful people from a selection of 20 photographs.

- If you correctly choose the 5 most beautiful people, then you are eligible for a prize.

What strategy should you employ?

A) Pick the 5 most beautiful people;
B) Other?

The naïve strategy would be to pick the individuals you think are the best looking. A better approach would be to form an opinion about what the crowd thinks and vote accordingly.

This approach can progress then into trying to predict what other 'rational agents' will do around the final outcome.

This can be applied to the stock market –

- Prices of stares are based on what people think about them – i.e. what everybody else would predict the average assessment to be – not their fundamental value.

Valuations

Valuations try to make sense out of uncertainty.

- There is always going to be uncertainty and it cannot be eliminated – our understanding go the past and anticipation for the future will always be obscured by uncertainty.

e.g. Use of valuations in stock or asset selection

The EMH at heart, suggest that financial markets are efficient and trying to outperform average is futile – matching the market is your best bet.

In reality, while generally efficient, there are bouts of irrationality

e.g. anomalies resulting from the market being too optimistic or pessimistic.

Share prices can change for any number of reasons

- Looking beyond prices for affirmation of an investment decision is necessary