CENTRE FOR FINANCIAL MANAGEMENT

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CONTENTS

PART A: ARTICLES/CASES

1. WISDOM OF THE MARKET

PART B: SNIPPETS

1. STOCK PICKING IS AN EXERCISE IN ELIMINATION
2. SETH KLARMAN :MARGIN OF SAFETY
3. FOUR AXIOMS OF QUALITY FINANCIAL REPORTING

PART C: WIT AND WISDOM

PART A: ARTICLES/CASES

WISDOM OF THE MARKET

The volatility of the market and its often erratic pricing of shares have often raised issues about the link between stock prices and economic fundamentals. Some notable authorities have at times even argued that stock markets seem to have a life of their own. A famous American investor Bill Cross claimed in 2012 that the U.S stock returns over the past 100 years "belied a commonsensical flaw much like that of a chain letter or yes- a Ponzi scheme." In 2014, Nobel laureate Robert Shiller, wrote, "Fundamentally stock – markets are driven by popular narratives, which don't need basis in solid facts." In 2017, another Nobel laureate commented, "We seem to be living in the riskiest moment of our lives, and yet the stock market seems to be napping.. I admit to not understand it."

Should the stock market be regarded as an arena where emotions reign supreme? Surely, for short periods of time- which may extend to few years- irrational behavior can drive a wedge between market prices and fundamentals. In the long run, however, valuation is driven by fundamentals. As the revered Benjamin Graham said the stock market is a voting machine in the short run but a weighing machine in the long run. Empirical evidence clearly shows that in the long run individual stocks and the market as a whole are driven by return on invested capital and growth. The implications of this for managers is that they should base their decisions on these fundamental drivers of value. By doing so, they can also detect and even exploit market irrationality if and when it occurs.

Markets and Fundamentals: A Model

There is a vast body of literature focused on investor behavior and market pricing. The general view is that market prices tend to gyrate around intrinsic value. A simple yet insightful model assumes that two types of investors trade in the market viz., informed investors and noise traders. Informed investors estimate intrinsic value based on fundamental analysis. Of course, all informed investors have their own estimates based on the information they access and the analysis they do. Some may estimate the value at 100, others at 120, and still others at 140, thus resulting not in a single point

but a range of 100 to 140 for the intrinsic value. Taking into account the margin of error and transaction costs, they will buy (sell) only when the stock price is less (more) than say 10 percent of their estimated intrinsic value. Noise traders hardly bother about intrinsic value. They trade on the basis of some news that may not really be material. For example, they may buy a stock when it rises by 5 percent or sell a stock when it falls by 5 percent.

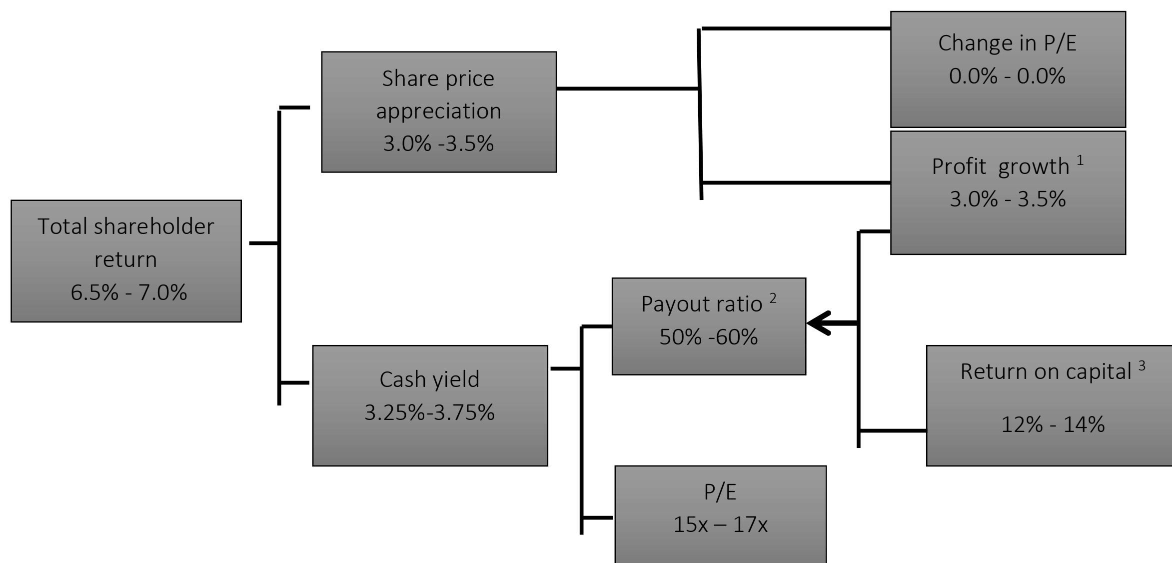
To understand what happens to the market price as a result of the interaction of intrinsic value investors and noise traders, let us say the price of the share is 70. Informed investors start buying shares because they assess the worth to be 100 to 140. Their actions push the share price up. When noise traders see the share price going up, they too start purchasing. This imparts further buoyancy to the share price and attracts more noise traders, as they don't want to be left behind As the share price moves upward, the informed investors become less interested. At 90, the most pessimistic of them stop buying, and at 110, they begin to sell, convinced that the shares are overvalued. As the price goes up further, more informed investors curtail their purchases and begin to sell. Once the price crosses 150, all informed investors turn sellers. This exerts a downward pressure on price. On observing this, some noise traders also begin to sell, thereby reinforcing the downward pressure. As more and more noise traders become sellers, the downward momentum is accelerated. It, however, slows down as informed investors begin to buy and at 90, all informed investors turn buyers. Finally, the decline in downward momentum induces noise traders to buy as well and this stops the price decline

Markets and Evidence

Empirical evidence, in general, supports the idea that growth and ROIC are the principal drivers of value.

Despite periodic bubbles and crises that have captured public attention and fueled the belief that stock market behavior is divorced from fundamentals, over the past 200 years, U.S. equities have delivered decade after decade a return of about 6.75 percent in real terms. Thus, over the long haul, the market has been far from chaotic.

According to McKinsey & Company, the explanation for this 6.7 percent total shareholder return (TSR) lies in the fundamental performance of companies and the long- term cost of equity. Their analysis is captured in the following Exhibit 1.



1.Measured in real terms

2.Estimated as (growth/ return on capital). Where real- terms profit growth plus inflation of 2.0% - 3.5%.

3.Long- term average ROIC- recent years have been above average levels.

Common Myths

The above evidence clearly makes a positive case for managers to focus their energy on growth at attractive ROIC.

Yet in practice managers nurture a lot of misconceptions and get distracted by a lot of things which tend to be counterproductive. The common misconceptions and distractions relate to the following.

- Earnings
- Earnings management
- Diversification
- Size
- Market mechanics
- Value distribution

Myths about Earnings Many companies use earnings per share (EPS) as a key measure of performance. They go to great lengths to achieve a certain earnings per share (EPS). They resort to share repurchases and acquisitions. They resist write- downs to reflect impairment of value and get concerned when accounting standards become more stringent impacting earnings per share (EPS) negatively. Their actions are misguided by certain misconceptions.

Misconception	A share repurchase programme that results in higher EPS creates value.
Reality	There is no correlation between the intensity of a company's repurchases programme and shareholder value creation.
Misconception	When a high P/E multiple company acquires a low P/E multiple company, the stock market values the acquired business at the earnings multiple of the acquiring company. So such transactions are value- accretive.
Reality	There is no economic logic or empirical evidence to support the view that the stock market values an acquired business at the earnings multiple of the acquiring company.
Misconception	The market reacts negatively to write- down of the value of assets. So write-offs should be resisted.
Reality	There is a no statistically significant drop in share prices on the day when write off is announced. Markets had already reflected the effect of bad decisions even though they were recognized belatedly in accounting.

In the early 2000s, a new accounting rule required employee stock options to be expensed in the income statement. Many executives and venture capitalists feared that this would reduce earnings of high growth companies and erode their market value. Academic research, however, found that the stock market already reflected employee stock options in its valuation.

Myths about Earnings Management There are several misconceptions surrounding earnings management. The reality, however, is different.

Misconception	Market pays a premium for steady earnings growth.
Reality	According to academic research, earnings variability has no impact on market value and shareholder returns.
Misconception	Providing earnings guidance for the upcoming quarter or year lowers share price volatility, increases market liquidity, and leads to higher valuation.
Reality	Empirical evidence suggests that earnings guidance does not generate benefits. On the contrary, earnings guidance can be dysfunctional because companies at risk of missing their own forecast are likely to resort to actions that boost short- term accounting performance at the expense of long – term value creation.
Misconception	Some managers believe that stock markets take reported earnings at their face value and get concerned when accounting standards become more stringent.
Reality	Share price data for companies that report different accounting results in different markets, however, suggests that stock markets reflect underlying economic reality and do not take reported earnings at face value.

Myths about Size Many managers believe that size and scale matter in improving ROIC and growth. Further, large companies enjoy higher market multiples as they are in greater demand by investors because they receive more coverage from equity analysts and media.

The evidence suggests that size matters up to a certain point but not thereafter. In the U.S. the cutoff point probably lies in the range of market capitalization of $250 million to $500 million. Beyond that it seems to matter very little whether a company has a market cap of $1 billion or $5 billion or $10 billion or more.

Myths about Market Mechanics There is a conventional belief that even if there is no improvement in underlying cash flows, the market value of a company goes up if its stock is included in a key market index, if it is listed in multiple markets, or if it splits its stock.

Empirical evidence, however, suggests that: (a) The effect of index inclusion/ exclusion is short – lived. (b) While a company from an emerging market may benefit from a U.S listing, there is no significant effect on shareholder value from cross- listing for companies in the developed markets.(c) Per se, stock splits don't create value. In many cases, stock splits are accompanied by positive abnormal returns to shareholders. But this has nothing to do with the stock split. As Tim Koller et. al explain, "The abnormal returns have nothing to do with the split as such but are simply a function of self- selection and signaling. Self- selection is the tendency of companies to split their stocks into lower denominations because of a prolonged rise in their share price."

Myths about Value Distribution A common misconception among executives is that dividends and share repurchases enhance value for shareholders. The demand from investors for companies to return more cash to shareholders reinforces this view.

The reality is that investors want more cash distribution not because the cash distribution per se creates value, but because investors are concerned that companies will squander excess cash over uneconomic projects.

Prices often increase when a company announces a dividend increase or a share repurchase. Why? In some cases, investors regard a dividend increase as a signal of managerial confidence about

future. In, other cases, investors feel relieved that management will not squander money over value-destroying investments.

Myths about Diversification Two common myths about diversification relate to the benefits of diversification and conglomerate discount.

Misconception	Diversification brings benefit in the form of more stable cash flows, higher debt capacity and better timing of investment across business cycles.
Reality	In developed markets at least there is no evidence of the benefits of diversification. On the contrary, evidence suggest that business units of diversified companies suffer a disadvantage vis- a – vis their more focused peers on account of complexity and added bureaucracy.
Misconception	Diversification leads to so – called conglomerate discount in relation to the fair value of the business. Hence divestment can remove the conglomerate discount.
Reality	This misconception is based on a misleading sum- of –the parts calculation, in which the valuation of various businesses is often based on industry peers that are not truly comparable. If analysis is done using true industry peers, the conglomerate discount disappears. Often there is a positive share price reaction to a divestment announcement. This, however, does not indicate any corrections of undervaluation by investors. Rather, it simply reflects the expectation of investors that performance of the parent as well as the divested business will improve once each has greater freedom to change its strategies, people, and organization.

(Adapted from *Valuation: Measuring and Managing the Value of Cpmpanies,* 7th Edition,Mckinsey & Company, Tim Koller, Marc Goedhart, and David Wessels, Wiley, 2020)

PART B: SNIPPETS

1. STOCK PICKING IS AN EXERCISE IN ELIMINATION

Sturgeon Law says 90 percent of anything is crap. Pareto Principle says 80 per cent of the outcomes come from 20 per cent of the causes. There are nearly 5000 stocks in the listed universe in India. According to the above laws, only about 500-1000 stocks are only worth looking into. To build a sound portfolio for the long term, an investor must be able to identify 10-20 good companies. This means picking stocks may be viewed as an exercise in elimination rather than selection. And in this a healthy dose of scepticism is helpful. To make good investment choices look actively for reasons for not buying a company. Some of the red flags which help in eliminating a company are: high leverage, low promoter holding, unreasonably high management compensation with respect to profits, qualified audit reports, frequent changes in auditors, huge discrepancy between profit and operating cash flow, low returns on capital, erratic dividend payments. Ignore complex investment thesis. If a lot of variables need to play out for company, avoid it. Investment wisdom consists in knowing what to ignore.

2. SETH KLARMAN :MARGIN OF SAFETY

Seth Klarman started the hedge fund Baupost group in 1983. Over the 35 years his hedge fund has delivered a return of over 20 percent per year, making it one of the top five hedge funds of the world. He has summarised his strategy in his book Margin of Safety. Seth Klarman's 10 rules of investing are:

1. Invest don't speculate

2. Don’t pay fees to Wall Street

3. Value investing is the best strategy

4. When you find a good value investments, try to buy it at as low a price as possible.

5. Be patient

6. Believe that the market is inefficient

7. Always have enough cash reserve

8. Don’t be afraid to average down

9. Trade to rebalance

10. Know what you are doing

3. FOUR AXIOMS OF QUALITY FINANCIAL REPORTING

An axiom is an unassailably true statement. It serves as a logical basis in a system of reasoning. The four axioms of quality financial reporting have been stated by Paul B.W. Miller and Paul R. Bahnson as follows:

“· Incomplete information creates uncertainty.

· Uncertainty creates risk for investors and creditors.

· Risk makes investors and creditors demand a higher rate of return.

· A higher rate of return for investors and creditors is a higher cost of capital for the firm and produces lower security prices.”

PART C: WIT AND WISDOM

1. HUMOUR

- **Shaw and Churchill**
  Bernard Shaw to Winston Churchill in a condescending tone, “My play is being performed tonight. Here are two complimentary tickets. You can bring a friend, if you have any.”
  Churchill in a supercilious tone, “I am very busy tonight. I will come for your play tomorrow, if it still runs.”
- **Wife**
  A wife begged her husband, “Honey let’s not fight this way!”
  “Why,” the husband asked, “Is there any other way.”

2. WISE SAWS

- At times, it is better to keep your, mouth shut and let people wonder if you’re a fool than to open it and remove all doubt J.G Sin clan.
- How a man plays the game shows something of his character; how he loses shows all of it.