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Pay A Price Get The Value

This article is basically regarding the value of stocks in the current economic climate. It's about recognising the under-valued stocks of various companies, and capitalising on them.

Value is Abstract

The role of market participants is to arbitrage by buying the under-valued and selling the over-valued stocks

Value of a stock is more abstract for it is a subjective figure in the mind of each investor be it an analyst, fund manager, owner, banker or an ordinary investor who participates in the pricing process directly or indirectly. Every stock has a value which may be unknown to most investors who provide different guesses to the actual value. Due to the different background of investors, each of them will attach a different value to a stock. Furthermore, the value of a stock may also vary depending on the objective of an investor (capital gain or dividend income), the time horizon of investment (short-term or long-term) and the expected return. It also depends on the risk profile of the investors.

Different Valuation

Different stocks can be or should be valued differently. An asset-based stock can be valued according to the tangible value of its assets such as cash and properties. Under normal circumstances, these assets can be liquidated and disposed off in the market easily. However, under the prevailing conditions where borrowings from banks are difficult and buyers are more cautious to invest, assets may not be able to fetch the right market value. Under such circumstances, it may be appropriate to give some discounts to the assets which are more difficult to sell. This is especially true for some companies where one or two of the term loans are due and refinancing may be difficult at that point in time.

Price Falls More Than Value

At any point in time, the price of a stock could be lower or higher than the intrinsic or fundamental value of the stock. Under normal circumstances and when the market is efficiently priced, most of the stocks will be traded around the intrinsic value **(see Chart 1)**. For whatever reasons, there may be some over-valued stocks and some under-valued stocks at any one time. The role of market participants is to arbitrage by buying the under-valued and selling the over-valued stocks such that stock prices reflect the true fundamental value.

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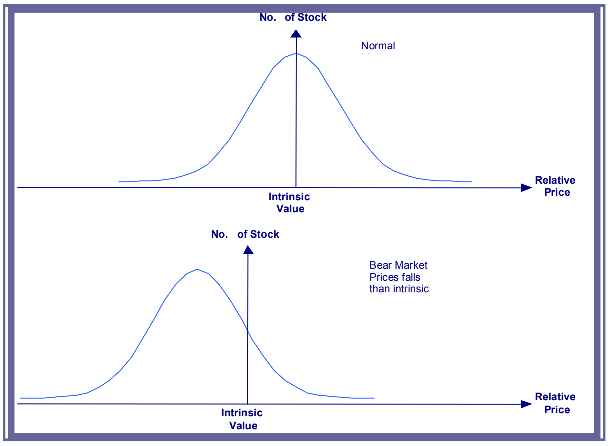
Chart 1: Bear Market – Price Falls



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Good management will take appropriate actions and pertinent strategies to overcome the economic slowdown.

In a bear market, when fundamentals deteriorate, the intrinsic value of a stock will also fall. But over a longer term, the basic components that make up the intrinsic value of a quality company will not change much. We have seen how most of the blue chips survived the Asian Financial Crisis and also continued to grow. Some have grown several times bigger **(see Table 1)**.

Main Value is Management

The main value of a company is the management. As long as it is still the same management running the well-proven company, much of the value of the company is likely to be intact. As an on-going concern, a company has a goodwill which encompasses its brand name, business reputation among customers, financials and creditors, established network of customers, a range of products or services which have been accepted by the market and etc. A proven management will have the ability to manage the business costs, the skills to identify capable employees, the aptitude to produce the right products for the right market, the acumen to determine the market trends and etc. Some of them may even take advantage of the present financial tremor to increase market share or acquire distressed competitors or other companies that are complimentary to the existing business.

When we invest in a company we are actually investing in the management who has been entrusted the stewardship to take care of shareholders' interest. They will sail the company through the stormy financial weather. They will take appropriate actions and pertinent strategies to overcome the economic slowdown.

Price Affects Value Too

Unfortunately, for certain companies the collapse of their share price does affect the values of their companies. This is especially true for highly geared companies. The fall in share price may have several implications on a company. When stock price falls excessively for whatever reason, confidence among bankers, fund managers and suppliers will drop. Sometimes force-selling on the owner's stock may also generate unwarranted anxiety among other stakeholders.

The slowdown of the economy would affect earnings over the next two years.

Even if the company is still operating well, the sharp fall in price will cast some doubts over the sustainability of the company, as the adage goes "there is no smoke without a fire."

A cash call to reduce borrowing will be difficult or almost impossible if the share price falls below the par value. During times of a financial crisis, banks are likely to be more stringent in lending or otherwise borrowing cost will be much higher. Without the new source of financing, some companies may have to sell-off valuable assets to payoff the debts and that affects the intrinsic values of the companies permanently. Even a cash call now will dilute the earnings of company due to issuance of larger number of shares at low price.

For majority of quality companies, the slowdown of the economy will affect earnings over the next two years and the management will take this as a challenge. Tackling the economic cycles is part of the duties of the management. As long as the management can weather through this difficult period, business will most likely be back to normal after the financial crisis.

Most well-managed companies in Asia will be faced with the economic deceleration but they will ride through the storm.

As long as there is still demand for the company's goods and services, business will be back to normal after the crisis.

Value Investing

As such, the reduction in earnings of a quality company during an economic downturn is only temporary. It may have one or two years of earnings setback, but that will not have much impact on the future cashflow and likewise with the intrinsic value. So long as consumers still consume and there is still demand for the company's goods and services, business will be back to normal after the financial crisis.

This type of forward looking investment philosophy is well understood by investment gurus like Benjamin Graham and Warren Buffett who always wait for such opportunity to grab "outstanding company at a sensible price rather than generic companies at a bargain price".

Margin of Safety

By buying stocks at a big discount from the intrinsic value, Warren Buffett is having good margin of safety, a concept which he postulates in value investing. By margin of safety, he means that downside risk is low. So long as he is not buying at the bottom, he may still suffer some losses along the way. But buying a stock at a big discount is probably a one-time chance in a decade. Without the financial crisis, a quality stock will not fall that much.

Quality stocks which did not fall, are definitely not a good choice.

In a bear market there are many investors who sell due to panic and there are also many who are forced to sell due to margin calls (banks and brokers sell the collaterised shares after the marked-to-market value of the shares fall below a threshold level). Some funds sell to meet redemption by their investors. Unfortunately, the disposals by a handful of investors caused the price to tank and affected the perceived market value of a company. The fear scattered during the current financial crisis deters even those who may have the capacity to buy from entering the market in a bold way.

Buy Fallen Quality Stocks

Obviously in an economic slump, stock prices fall. Some suffered more losses, while some held up quite well. Poorer-grade stocks which most likely have fallen more are only good for trading but now is not the time. Those who buy for a short-term capital gain are only hoping to catch a technical rebound.

Investment must be on quality stocks especially those that have fallen in line or more than the market (See table 2). Quality stocks which did not fall are definitely not a good choice at this point in time. In fact, investors may want to sell these stocks and switch to other similar stocks which have fallen.

Table 2: Buy Quality Stocks After Price Fallen

	Poor Quality Stock	Good Quality Stock
Price Fallen Less	Sell Poor quality stocks which are artificially supported	Prices of quality stocks that held up well do not pose investment opportunity
Price Fallen More	Cyclical, highly geared and poor quality stocks have their share price bashed down	Buy quality stocks after prices have fallen

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