The Wrap Up

Come Count With Me

As both Canada and the US celebrated their national holidays, the week was fairly quiet on news and developments. The most noteworthy highlights were the jobs report (209,000 new jobs added in June, slightly below consensus) and the Fed minutes suggesting that a rate hike in July is likely. There was some volatility to note, with markets down on Thursday; a combination of profit taking and pricing in higher interest rates. With that, we want to talk about what it means to 'price in' rate hikes or how we come up with equity valuations in the first place.

To the surprise of many, the value of a share is not an arbitrary number, at least not in the medium to long term. In the short term, share values can stray away from their fair value, however, in the medium to long term, share price valuations are sensitive to cashflow or profit generation. At this point, there should be no surprises; it seems natural that a company that can continue to generate increasing amounts of money will be rewarded with a higher valuation both on an absolute basis (that is the company is worth x+1 because of the profit it generates) but also on a relative basis (the company is worth x+1 versus its closest competitor because it has higher profit growth). The approach of using information about earnings, cashflow or even economic growth, is referred to as fundamental analysis. A portfolio manager will assess a valuation using fundamentals and will then compare that valuation to the actual share price and make decisions based on that comparison.

There are three commonly used methods to value equities: present value models, multiplier models, and enterprise-value based models. Most analysts will use more than one model and depending on the sector in which the company operates or where the company is located in its growth cycle, some models are more appropriate than others. A present value model estimates the value of security as a present value of future benefits, be it using dividends distributed to shareholders or free cash flow available to shareholders. A very simple example of the dividend discount model that would be used to value a company would be as follows: the next 3 years of dividends are expected to be $1, $1.1 and $1.2, the shares are expected to trade at $12 at the end of the 3 years and the required return on the shares is 10%. The math is as follows:

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$$\text{Value} = (D1/(1+r)) + (D2/(1+r)^2) + (D3/(1+r)^3) + (P3/(1+r)^3)$$

Where D1 is dividend is year 1, D2 is the dividend in year 2, D3 is the dividend in year 3, R is the 10% required return and P3 is estimate share price in 3 years.

$$\text{Value} = (1/1.1) + (1.1/1.1)^2 + (1.2/1.1)^3 + (12/1.1)^3$$

$$\text{Value} = \$11.73$$

The example provided is a simple one but it still illustrates the point. When you think about it, it makes sense for the shares to trade today at $11.73 ; as the required return is 10% and the dividend is growing just below 10% per year, the share price today, will not be too far off from its estimated value in 3 years. Something important to consider is the required return estimate; this figure is what is sensitive to factors such as risk and interest rate levels. Think about it; in a low interest rate environment, the risk free rate of return is low, therefore my required return in order to take risk in a company is also lower. As rates go up, the risk free rate also rises which means investors look for higher returns every time that they take on risk. Briefly, assuming that volatility is constant, a market return of 8% is more appealing when GIC rates are at 1% than at 5%. As mentioned previously, the appropriate model must be used for the right company; we cannot use a dividend discount model for a company that does not pay dividends.

Multiplier models are commonly referred to as these figures tend to be easily available and are easy to compare to other companies. The most commonly cited multiple is the price to earnings ratio, or, the P/E ratio (derived by dividing the current price per share by the earnings per share of a company). This ratio is often used to compare companies to other companies or against sector averages. An example of this would be: as of today, Bank of America trades at 8.51x earnings while JPMorgan trades at 10.56x. While Bank of America trades at a lower multiple than JPMorgan, there could be several reasons why: do they have similar growth rates? Similar earnings quality? Is management performing better at one firm versus the other? Essentially, is the premium that JPMorgan trades at relative to Bank of America justified? This is what an analyst seeks to answer before deciding which of the two shares to buy. The P/E ratio has its limitations; you cannot apply it to companies that do not make money, as earnings (profit) is an accounting figure, it can be distorted by one-off items (such as writing down the value of asset). It is also best applied to companies within the same sector as the multiple varies greatly within the market (NVIDIA has a P/E ratio of 218.8, Microsoft at 36.99 while British Petroleum trades at 4.09).

Enterprise valuation models are used more frequently in Europe or for takeovers as they encompass the entire value of the company including market capitalization (the value of all the shares that trade on the market) plus the value of all the preferred shares and the value of the outstanding debt (minus cash of course). A commonly used model is the EV/EBITDA ratio; where EV= enterprise value and EBITDA = earnigs before interest, tax, deprecation and amortization. Oftentimes, companies post negative earnings but positive EBITDAs; when you cannot use the P/E ratio, this alternative is sometimes more appropriate.

Why did we decide to cover valuation models today? Simply put, the large fluctuations in economic outlooks and interest rates have led to large gyrations within the market itself, making it difficult to generate a fair value estimate that will not have to revised, drastically, in the short term. What's important in these volatile times is to know what you own, why you own it and to be less sensitive to short term fluctuations; good companies are volatile too in these times but as long as the long term thesis remains intact, we should continue to hold, if not add to our positions when opportunities present themselves. After today's "lesson", I hope that our clients can appreciate the story, or the math, that goes behind our recommendations!

Healthy Distraction

After the impromptu FINA 201 lesson, I wanted to thank those readers that haven't given up on this week's reading! As a reward, what better distraction than one that can inspire and motivate us; the story of Arnold Schwarzenegger! Netflix recently released a three part mini series documenting his life, and as someone who grew up idolising the movie star, it was a wonderful viewing experience.

The documentary covers the three areas of his life where he found success: bodybuilding, movie making and politics and what is most inspiring is that he accomplished all this on his own. Born in Austria, shortly after the Second World War, it was his sheer willpower and motivation that led him to become the success that he is today. The series does not shy away from humbling moments either, be it box office failures or the breakdown of his marriage due to fathering a child with another woman.

Listening to him recount his life, owning his mistakes, celebrating his successes and sharing his philosophy towards life will resonate with you and may even motivate you when you need it most!

Happy Friday!