

# Free present value analysis of securities essay example

[Business](#), [Marketing](#)



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## **Introduction**

Investors are interested in knowing the intrinsic and market value of a company so that they can make wise investment decisions based on the available information. In determining the monetary value of a business, investors use the following three methods:

Asset approach- this method looks at the liabilities and assets of a business. The difference between the assets and liabilities is the business value.

Market approach-this method is based on the market forces of demand and supply in arriving at an equilibrium price acceptable to both the buyer and the seller of the company. This makes the fair market where each party acts out of full knowledge on the available facts about the operation of the market (Prasanna, 2011).

Income approach- this method is grounded on the economic principle of expectation. Investors look at the monetary benefits of investing money, time and effort in a business. They also factor the risks and uncertainties associated with such an investment so as to make informed decisions on the right course of action. The method uses capitalization and discounting rate to determine the worth of a business (Lawrence, 2008).

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These three methods have similarities in that they objectively aim at establishing the present value of a business. This helps investors to decide on whether or not to buy the business. In the contrast, it may not be objectively clear which assets and liabilities to include in the valuation and how much each is worth. Also, investors may not have full knowledge about the market in situations where there are cartels in the market. Investor valuing business using income approach may not objectively determine how much to get as profits and how much risk to expect since there are external influences (Stephene, 2013).

The Efficient Market Hypothesis forms are: strong form-this occurs when the information held by the public about the value of the shares is rapidly and precisely reflected in the prevailing market price. The market price is arrived at through the forces of demand and supply. It's the most compelling despite having a drawback that it can't easily be confirmed empirically. The second one is the semi-strong form-the information held by the public about the prices of the shares should be reflected in the market price. Share prices are influenced by the forces of demand and supply which settle the market at equilibrium. It's the best unbiased predictor of the share prices based on the information available to the public about risks and returns on investments. The third is the weak-form- this looks at a section of historical information held by the public about the share prices. Based on that information, it assumes that information about share prices should be reflected by the market price. It also uses past empirical data to make decisions about the future investments. The Efficient Market Hypothesis has the following anomalies: It uses past empirical data to make decisions about the future

and in reality this past data is immaterial in making future investment decisions. Investors mostly make unsupported conclusions about the cause of the previous profits and losses. They also do not rationally calculate the value of investments by determining the present value and future cash flows. They are mostly influenced by the mass-mind (Prasanna, 2011). Compounding periods impact the present value of an investment by increasing it with time. The many the compounding periods, the more the value of an investment is. This is supported by the following worked out illustrations: an investment whose present value (PV)=\$2000 is compounded at an interest rate (i)= 20% for three compounding periods,  $t=[1, 2, 3]$ . The present value increases as follows (Prasanna, 2011).

Period 1;  $FV = PV (1+i \%)^n$ ;  $2000(1+0.2)^1 = 2400$

Period 2;  $FV = PV (1+i \%)^n$ ;  $2000(1.2)^2 = 2880$

Period 3;  $FV = PV (1+i \%)^n$   $2000(1.2)^3 = 3456$

## **Conclusion:**

Compounding periods increase the present value of an investment as time goes by.

## **References**

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Lawrence J Gitman: Principles of Managerial Accounting, 11th ed, (2008) Pearson Publishers.

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