Equity valuationand analysis

Introduction The quotes present a very interesting indication of how most of the investors tend to behave on stock market and are led by the behaviorwhich may be termed as herd behavior. A closer analysis of the information presented in the quote will provide a clear indication of how the stocks are valued by the investors and under what influences.

Evaluating the investments based on the discounted cash flows is considered as the best method to find out the true value of the stocks and any other methods may lead to the different valuation of a security. This paper will therefore reflect upon the use of discounted cash flow method and will discuss whether it is an appropriate method to value investments.

Discounted Cash Flow Method

The given quotes indicate that the general principles adapted by the market participants do not include the use of discounted cash flow method. Most of the market participants use their professional judgment in valuing the securities and their judge their returns rather than using more sophisticated methods to value securities.

Literature on investment and corporate finance indicates that the best method to find out the value of any investment is to discount the future stream of cash flows that an investor expects to receive with an appropriate discount rate. This discounting of future cash flows i. e. dividends, therefore lead to finding out the intrinsic value of an investment. The critical difference between intrinsic value of any investment and its market price lies in the fact that intrinsic value is what the value of security should have been and market price is the actual money placed by the market on that security. The difference between the two values therefore indicates whether a security is under-valued or over-valued. Value investors therefore often tend to find out this difference in order to make their investment decisions.

It is also important to note that the discounted cash flow method takes into account the element of risk which other methods fail to integrate. The discount rate which is used to discount the future streams of cash flows takes into account the risk premium which compensates an investor for taking risk by buying a particular security. Discount rate is often calculated with the help of Capital Asset Pricing model which is based upon the risk free rate, the correlation of individual security returns with that of the market returns and the market risk premium. Thus if an investor uses discounted cash flow method to find the true value of an investment, the element of risk is already incorporated in the value based on the overall risk profile of the security.

Conclusion

Investors often make decisions based on their gut feelings and tend to over-react or under-react to the short term market swings and subsequently make their investment strategies based on such information. More prudent approach however will require the proper use of discounted cash flow methods to find the true value of the securities and than subsequently base the decision on this value.