

BUSINESS ANALYSIS & VALUATION

5e

USING FINANCIAL STATEMENTS
Text & Cases



Chapter 9: Equity Security Analysis

Key Concepts in Chapter 9

- Security analysis is one step in the overall process of maximizing progress toward an investor's objectives.
- Security analysis is conducted by a variety of individuals for different purposes.
- For most analysts, a key objective is the identification of mispriced stocks.

Investor Objectives and Investment Vehicles

- Investor objectives are highly idiosyncratic and must be matched with the appropriate investment.
- For example, individuals must consider risk tolerance, tax rates, stage of life, other assets, among other factors.
- There is a vast array of domestic and international debt and equity instruments, as well as mutual funds that hold combinations of either or both.

Equity Security Analysis and Market Efficiency

- The **efficient markets hypothesis** posits that security prices reflect all available information fully and immediately upon its release.
 - Perfectly efficient markets would make it impossible to identify mispriced stocks using public information.
- The role of financial statements
 - If markets are extremely efficient, the few who receive newly announced financial information could trade advantageously on it before it is fully disseminated to the rest of the market.

Evidence of Market Efficiency

- Much empirical evidence supports the primary U.S. securities markets having a high degree of efficiency. Some evidence includes:
 - Market reactions to public announcements are quick
 - Specific mutual funds or analysts who consistently generate abnormal returns are difficult to identify
- Some studies in recent years have re-examined the widespread acceptance of the efficient market hypothesis.

Approaches to Fund Management and Security Analysis

Approaches are quite varied as illustrated by the following contrasts:

– **Active vs. passive management**

- Active management relies heavily on security analysis, while passive management typically seeks to match some benchmark of performance through holding a portfolio of securities.

– **Quantitative vs. traditional fundamental analysis**

- Technical analysis attempts to predict stock price movements based on market indicators. Fundamental analysis attempts to evaluate current market prices relative to future projections of earnings or cash flows.

Approaches to Fund Management and Security Analysis, continued

- **Formal vs. informal valuation**
 - Formal valuations are of the type described in Chapter 7. However, less formal analyses such as comparing analyst opinions or consensus forecasts have become popular.

The Process of Comprehensive Security Analysis

- A generalized security analysis framework is useful, given the variety of approaches that may be taken.
 - Selection of candidates to analyze
 - Specialization by industry sector or potential mispricing basis allows more depth of analysis.
 - Inferring market expectations
 - Identifying potentially mispriced securities requires a comparison of the analysts expectations with those of the market.
 - See Table 9-1 for an example of analysts' forecasts under different scenarios

TABLE 9-1**Assumptions About Value Drivers for GE Consistent with Observed Market Price of \$18.86 (Assuming 11.2 Percent Cost of Equity Capital)**

Analysts' Mean Earnings Forecast Through 2013	2011	2012	2013	2014	2015	Post 2015
Earnings Growth	27.4%	23.0%	18.7%	12.0%	12.0%	3.2%
Earnings Per Share	1.35	1.66	1.97	2.21	2.47	
Return on Equity	12.1%	14.5%	16.5%	16.5%	16.5%	

Source: © Cengage Learning 2013

The Comprehensive Security Analysis Process

- Developing analyst's expectations
 - Forecasts of earnings and cash flows along with an estimate of value must be derived from the analyses performed
- The final product of security analysis
 - Financial analysts must ultimately recommend some action to take on a security based on the analyses conducted.

Performance of Security Analysts and Fund Managers

Analyst and fund manager performance has been the topic of extensive research.

– Performance of sell-side analysts

- Sell-side analysts have incentives to be overly optimistic with their forecasts and recommendations
- Recent research indicates that these analysts' recommendations outperform market index and risk benchmarks
- Research indicates that analysts play an important role in market efficiency

– Performance of fund managers

- There is no consistent evidence that actively managed mutual funds produce superior returns for investors.

Concluding Comments

- Security analysis is part of a larger process that involves:
 - Establishing investment objectives
 - Developing expectations about future returns and risks of individual securities
 - Combining individual securities into portfolios that meet investment objectives
- A large body of evidence exists supporting a high degree of efficiency in domestic markets, but recent studies have re-explored this issue.