Chapter 19

Understand the Benefits and Limitations of Common Valuation Methodologies

> Valuation is easy. The tough part is fundamental analysis.
>
> —*Phil Friedman, former Morgan Stanley Portfolio Manager, John Levin and Co. CIO, and Perella Weinberg Partners Hedge Fund Manager*

Introduction

As highlighted above, some analysts overcomplicate valuation. While it's a critical tool for stock picking, many analysts forget that it's just a tool and not a panacea. When analysts make shaky stock calls, they often confuse challenges in valuation with the real problem, which is assessing the probability, timing, and magnitude of the critical factors—elements that can only be better assessed with more thorough fundamental analysis.

The topic of stock valuation is a large discipline, as evidenced by 10,000 results coming back from a book search of the term on Amazon.com. Given its complexity, I can't explore all of its dimensions, but I can focus on the best practices that equity research analysts use to derive sound valuations for their stocks. Here are some of the broad steps they use when conducting stock valuation:

- They have full command of *historical* valuation parameters for their stocks, or classes of companies, specifically those with similar financial characteristics, which is critical for understanding the valuation levels likely to be afforded in the future.
- They are diligent in understanding why the market values their stocks at *current* levels.
- They appreciate the limitations of the most traditional valuation methods, such as price-to-earnings (P/E), price-to-free cash flow (P/FCF), price-to-book (P/B), price-to-earnings growth (P/EG), and discounted cash flow (DCF).

Selecting a Valuation Method

The first tangible steps in valuation should include acquiring the following knowledge:

- For every stock in the assigned universe, identify the valuation method(s) currently being used and any methods used in the past.
- If more than one, identify the catalyst(s) that caused it to change.
- Determine if there are similar catalysts that could cause investors to look at a new valuation method over a reasonable investment time horizon.

The best way to get these answers is by speaking with individuals who trafficked in the stock in the past. (Elements of this were recommended in Chapter 8, as part of a preliminary step to determine "what's in a stock.")

Read the rest of this chapter in the full version available at Amazon.com

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