

## **How to value shares - a definitive guide**

With the valuation of shares, there are a lot of different ways to go about it. Each well known investor from Benjamin Graham to Charlie Munger to Warren Buffett have had their own particular way to do it.

As such, each method produces different results and opinions on the valuation of a particular company. Therefore, the act of valuing shares is more art than science with results being less than definitive.

When thinking about shares, one should understand that the shares typically represent a small piece of a company; a partial ownership stake in a business.

When thinking about businesses, the numbers only tell part of the story.

### **The Storied History Behind The Numbers**

A company history is useful – both recent and historic – as well as knowing its strategic objectives going forward. Unless partial ownership is intended to last mere months, one needs to get to know a company well.

Reading the annual reports, familiarising oneself with the products or services offered, and getting a good sense of the business are all vital steps in this learning process. Someone with a keen interest and a love of learning could well enjoy this discovery process.

### **Using Business Knowledge With Investment News**

Without a detailed knowledge about a business, one will not be able to interpret company and industry news, or correctly judge its implications. Does the latest news mean one should consider buying more stock? Does it mean one should consider selling the whole position? Without knowing clearly the reason why the investment was made and on what basis the position continues to be held, one will not know when it is the right time to sell.

### **Thoughts on Value**

When it comes to value, billionaire investor Warren Buffett of Berkshire Hathaway perhaps had the most to say about valuations:

**“Price is what you pay. Value is what you get.”**

<http://www.brainyquote.com/quotes/quotes/w/warrenbuff149692.html>

Buffett also later commented:

**“Of course, a business with terrific economics can be a *bad investment* if the *price* paid is excessive.”**

The latter may at first seem like an illogical statement. What Buffett was pointing out is that if a share is overpriced when purchased, then the future growth of the stock price, and the subsequent dividends received, are likely to be artificially lowered.

At a certain point, all stocks revert to their mean valuation. An investor who overpaid, can get left holding the bag when the music stops. Furthermore, if one pays too high a price for a stock, the current yield on the cash dividend will be lower too.

For example, if a stock is priced at £100 per share and pays an annual cash dividend per share of £4, then the cash yield is 4%. If the investor does not become interested in the company until they see articles raving about the meteoric rise of the share price, then they may have only chosen to buy when the stock reached £200 per share.

Assuming the cash dividend has remained unchanged, they will receive the £4 payment, but this will now only be 2% of the purchase price. As such, the per share income is the same from the investment (£4), but the investor paid twice as much (£200) to buy that stream of future cash dividend income.

One measurement of investment return is cash dividend plus share price growth, so by purchasing a lower stream of future cash dividends, the long-term return will be lower too, because the price paid was higher.

At times like this, it is useful to learn the historical average dividend yield of the business or the market as a whole, to have some basis for comparison otherwise one risks overpaying.

## **Thoughts on Cash versus Deploying Capital**

When one considers putting money into collective investment schemes like investment trusts or OEICs, the fund manager(s) will have a pool of investment funds to deploy. They are under pressure to deliver results rather than have the cash sitting idle earning very little.

When it comes to seeking value, the pressing need to be active with the pool of investment funds forces fund managers to invest even when the market as a whole is overvalued and company shares representing good value are low on the ground.

Investors refer to having cash sitting waiting to invest as "dry powder". If all the money is invested in average companies priced unreasonably high, then not enough cash is available when exciting investment opportunities are subsequently discovered.

The patient investor is often rewarded, but it takes a certain kind of person to sit on their money while they wait. Waiting for the good pitch, rather than

swinging for the fences with every ball, can deliver more to the patient person than just a better batting average.

## **Valuation Basics**

There are a number of different ways to go about measuring the value of a stock.

These include:

- Price to Earnings (P/E or PE)
- Shiller's PE10
- Smithers'  $q$  ratio
- Price to Book (P/B)
- Price to Sales (P/S)
- Dividend versus Historical
- Valuation compared to a similar company

Some of the best sites to get a free price quote for a listed stock is <http://markets.ft.com/research/Markets/CompanySearch>

Here the quote will include several of the valuation metrics mentioned above, such as PE, PB, and current yield.

## **Price to Earnings (P/E or PE)**

The most commonly used metric is price to earnings or PE.

The price is the stock price. The earnings are the earnings or profits, after taxes.

For example:

If a company had earnings of £1 per share last year and the shares are presently priced at £10, then by dividing the share price by the earnings, one can get the PE ratio. In this case, the PE is 10.

PE ratios vary from industry to industry, stock market to stock market. Developed markets are typically priced higher than emerging markets like India, Malaysia, etc. Companies in the financial industry have often had a PE of around 10 when they are fairly valued in the UK, whereas a consumer products company would be historically fairly valued at a PE of 13 or 14.

On occasion, investors feel that premium companies still represent good value at a premium valuation like PE 18 or PE 20. Warren Buffett has bought shares of Cola Cola stock at such valuations and done well. Here, his assessment was that Coke buys back its own stock regularly and manages growth well, so it was likely to grow faster than another investment and so the high pricer was warranted.

## **Shiller's PE10**

Professor Robert Shiller, a prominent economics professor, determined that the PE ratio was more accurate when the earnings were smoothed over a 10 year period, rather than for a particular snapshot in time.

This method is perhaps more useful when reviewing industry sectors or whole markets than an individual company share.

Professor Shiller's updated valuation charts, starting the US S&P 500 Index are here:

<http://www.multpl.com/shiller-pe/>

## **Smithers' $q$ ratio**

Smithers of Smithers & Co. wrote a book about his  $q$  ratio and it is used by his investment consulting firm.

The idea behind the  $q$  ratio is to come up with a single number which determines the replacement cost of a company or market. The values will be 1.0 for being priced at replacement cost, lower if under-priced and greater than 1.0 if overpriced. The long-term average is 0.63.

The business reasoning for the replacement cost is the idea that if a company becomes so expensive that the entire business could be reproduced from scratch for less, then investing in such a company makes little sense.

<http://www.smithers.co.uk/faqs.php>

## **Price to Book (P/B)**

This is calculated by taking the latest share price and dividing it by the last quarter's book value per share.

Book value gives more emphasis on the value of fixed assets like buildings and machinery. As the value of many businesses are no longer based around these kind of assets, book value has less benefit as a valuation indicator than in previous decades.

## **Price to Sales (P/S)**

With price to sales, it is useful to look at the historical P/B for the company and the industry. This can provide an indication of whether the share price is riding up ahead of growing sales or falling faster than declining sales.

Price to sales is not widely used as leading measure for valuation, but can be one piece in the valuation puzzle. Price to sales varied widely between different industries.

## **Dividend versus Historical**

Dividend ratios (dividend divided by share price) can provide a strong extra metric when looking at PE ratios. It is like coming at the valuation problem from a different angle.

Understanding market levels now and historically can be a useful thing. The same applies to dividend levels and payout ratios (percentage of earnings that are paid out as dividends).

Historically the UK's FTSE 100 index has had a dividend yield of approximately 4.7% over the last century. With the American S&P 500 index, the historical dividend was 4.4% over a similar period.

Real growth rates (above inflation) were 1.1% for the UK and 2% for the US. The difference was largely reflected in high inflation levels in the UK.

In more recent times such as before the stock market crash of April 2000, the US market P/E reached 48 (remember the average is closer to 14) and dividend yields on the S&P 500 index fell to well under 2%.

Armed with the above information, it is not different to see that in April 2000 while the market euphoria had reached a peak, US markets (followed by the UK markets too) were overvalued by 2-3 times. The technology NASDAQ index was so wildly overvalued that in the crash stocks corrected their valuations by 80%.

In April 2000, investors like Jim Rogers (formerly of the Quantum Fund which he co-managed with George Soros) was using this information to call a market top and suggesting a market crash was coming. However, few listened and many later claimed to not understand why the market fell. Informed investors knew better.

## **Valuation Compared to a Similar Company**

It is also possible to use valuation comparisons with competing companies in the same sector to get a sense of values in the sector. Sometimes a number of companies are all overvalued together, whereas other times investors like the investment story from one particular company, and have left a diamond sitting out at a cheap price.

## **Final Thoughts**

The best indicators of value are price to earnings and dividend ratios, though opinions do vary obviously.

Some investors believe that a steady and reliable stream of income from cash dividends demonstrates astute management who will not waste retained

earnings on pet projects that fail to produce expected growth.

Other investors dislike that cash dividends are taxed in the year that they are paid, and prefer to own stock that pay few dividends & to defer their capital gains tax until when they sell their shares.

Both points of view have merit and which is best will largely be a personal choice for each individual investor based on their own preferences & investment objectives.

While market valuations can keep rising as markets shoot up, creating a "raising all boats" effect that temporarily makes all investors look like geniuses, buying low and selling high remains a simple measure for success that has stood the test of time.