Monash Investors on Pricing Stocks

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Co Portfolio Manager and Founder

Working out what something is worth is the key issue confronting investors.

There can be no precise answer when it comes to valuing stocks because there are too many uncertainties.

But investors can use this to their advantage.

Overview

- Market participants use many ways to value companies
- In the end, what matters is what works – and different approaches at different times can suit different investment managers with different styles
- At Monash Investors we mostly use a Discounted Cash Flow (DCF) approach for a variety of reasons that we set out below
- We value stocks on an absolute basis versus adopting a relative approach because we are targeting absolute returns
- We allow for uncertainty and imprecision when pricing stocks

Valuing Stocks: two components

A fundamental aspect of an investment manager's job is working out what a stock is worth. There are two parts to this.

1. The first involves analysing, modelling and forecasting the future of the business, to produce estimates of future earnings per share, among other things. Doing it thoroughly requires access to all sources of public information, multiple skills (accountancy, mathematics, interpersonal) and of course wisdom. But that doesn't tell you what a stock is worth.
2. Even after all that has been done well, you need to use that information to do the second part, which is pricing the stock.

In the same way that good analysts can differ in their forecasts, for example by having different expectations for revenue growth or EBIT margins, fund managers can also differ in how they price those forecasts.

Now, there is more than one way to skin a cat, and there is more than one way to price a stock, even as a fundamental manager. Investors can vary on the emphasis they give to one measure over another, for example Price to Earnings, Price to Growth or Cash Flow per share. Another big difference is whether they are pricing a stock on a relative basis or an absolute basis.

The "Fair Price"

As an absolute return focused fund manager, Monash Investors is interested in calculating what we believe the price of a given stock is worth today. That is to say, if the market had the same expectations of future business outcomes that we do, what would be a fair price for the stock to-day.

This is the key point.

We are not saying that we think xyz will happen over the next few years, and as a result, the share price of a stock will hit a price target two years from now, or that we have an "investment horizon" of two or three years. Instead, we are asking ourselves that given what we know about a stock and our reasonable expectations for its future as a business, what price should the stock trade at to-day, if the market had the same understanding right now that we have? The difference between our target price and the current price is the amount to which a stock is mispriced; we call this mispricing the "pay-off" and it can be to the upside or the downside.

Setting the Bar High

At Monash Investors it is our view that most stocks are fairly priced, most of the time. By that we mean they are priced to within 10 or 15% of what they are worth, so that there is an upside that makes it worthwhile to invest in the stock market. Monash Investors is not particularly interested in these stocks. Stocks like these are the bulk of the index, which means they are also the bulk of most fund managers' portfolios. Because stocks can move around by 5-10% on little news, most fund managers deal with this by having lots of bets, and if they can get 55 or 60% of them right, they will outperform the index.

However, we can see each year that significant mispricing has occurred, with a number of stocks moving up or down by more than 50%, as the next section highlights.

Price moves over the 2016 Financial Year

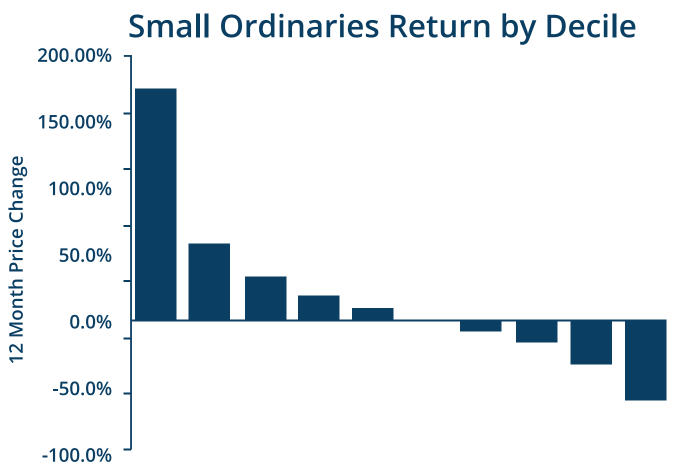
If we take the stocks in the ASX100, the arithmetic average of their price moves over the 12 months to 30 June 2016 was +9.6%, but there was a wide dispersion in returns as Chart 1 shows. The best 20 stocks averaged price moves of +58% and the worst 20 did -25%.

Chart 1- each year stocks in the index show a wide dispersion of returns

Further, over the same period to June 30 2016, the Small Ords (the ex100 stocks in the ASX300) did much better than the large stocks but the pattern was similar. The arithmetic average of the Small Ords was +18%.

The best fifth of them averaged +116% and the worst fifth -48%.

Monash Investors looks for stocks (long and short) that show these characteristics.



Monash Investors is very interested in stocks that can move up or down in meaningful ways, and seeks to identify them in advance, where it is possible to do so. We do this by relying on recurring business situations or patterns of behaviour, which we have observed over our careers, which inform our forecasting. These recurring situations also allow us to set the bar high and we target a success hit rate of 80%, rather than 60%.

For the majority of our investments we are looking for a combination of the following four attributes, which we refer to as **GIVE:**

- **Growth** We want to see strong growth in sales, earnings and/or cash flows for stocks that we look to buy, and the opposite for stock we look to short.
- **Insight** We need the stock to be misunderstood in some way by the market, and to anticipate how this will be resolved. We don't want to be like the patsy at the poker table who doesn't know who the patsy is.
- **Value** A payoff (the difference between the target price and the current price) that will meet the high hurdles we set for returns.
- **Event** A near term catalyst, if possible.

Target Prices

So now we come to determining the target price. As I noted above, there is more than one way to price a stock, and whatever the method chosen, it will give different results if different assumptions are made.

Different valuation methods have different advantages and disadvantages, and some are suited to particular styles of investing, more than others.

Growth Measures

Price / Earnings ratios (P/E) are quite simple to calculate and allow a quick comparison between stocks. However, in order to compare like with like, complex adjustments have to be made. Many companies have different months for their year ends. The earnings year chosen as the denominator (eg Year 1 or Year 2) is also very important because company earnings are volatile from year to year. Further complicating this "simple" measure, there needs to be an allowance for future growth rates and risk (financial risk and operational risk) both of which change over time, too. While P/E ratios are very useful for relative value managers who are trying to compare similar companies, they are not as helpful in comparing dissimilar companies because the adjustments required to compare them are hard to stay on top of and lack transparency.

A variant of P/E is the Price / Growth ratio (P/G) which compares a stock's P/E to the growth rate of its earnings per share (EPS) in a future year. P/G is an even less theoretically sound valuation tool than P/E and is not used by many professional investors.

Value Measures

A value investor may wish to focus on Price / Book (P/B) or Price / NTA (P/NTA) as a better measure of absolute value per share, but this has become a much less popular measure over the decades as more and more companies have become asset light. It can be paired with a measure of Return on Equity (ROE) to adjust for differences in asset turns and Return on Assets (ROA) between companies and industries, but even then it suffers from being an imprecise snapshot in time.

There are more measures of relative value that are used – Dividend Yields, Free cash flow yields, Enterprise Value to EBITDA, even Price to Revenue. While superficially they appear simple, in reality they all need to be adjusted substantially in order to compare differing companies.

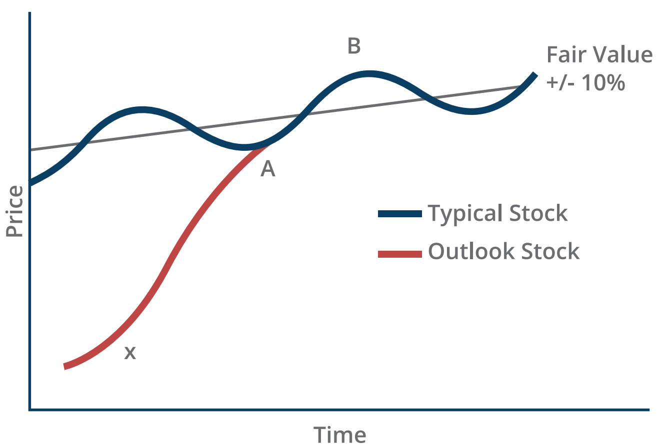
Combining Growth and Value – The Monash Investors Approach

At Monash investors we tend to rely more (but not exclusively) on absolute measures of value such as Discounted Cash Flow (DCF) and Dividend Discount Model (DDM). These approaches use cash flows into and out of the business that result from all the analysts work around revenues, margins, capital expenditure, debt ratios and dividend policy. A risk adjusted interest rate is used to discount the value of future cash flows.

The major criticism of DCF methods is the sensitivity of the output to interest rate assumptions. This is a particular problem for any fund manager that is chasing only small level of mispricing in stocks, and by that I mean the 10-15% upside within which most stocks seem to trade. This is much less of a problem for the sort of stocks that Monash Investors is targeting, with upside/downside pay-offs of 60% or more. In any case, we typically take 10% off our calculated valuations in order to set a target price, as Figure 1 highlights, to avoid the 'noise' or forecast and valuation uncertainties associated with pricing a stock.

This also contrasts Monash Investors with managers that are just playing in the last 10%.

Figure 1 – Typically the valuation of a stock will increase over time as it grows (shown by the black line), and it share price will move around its valuation based on any number of factors, such as news flow. Monash is looking for stocks that are likely to experience a step change in their valuation due to a change in their business (eg product rollout, geographic expansion, cyclical industry drivers etc.). That is, they are trading at point X, but if the market was discounting our insight into the company it would be trading on the black line. Monash prefers to invest when at point X and exit at point A, we are happy to leave the last 10% of other investors to quibble about.



DCFs require more work – but it's worth it

While DCF valuations take more work to calculate than Price ratio valuations, DCFs allow the effect of medium to long term business growth and balance sheet changes to be explicitly priced, and the result is a valuation with a strong theoretical basis.

Our view is that there is enough imprecision in the forecasts, so we need to cut down the degree of imprecision in the pricing methodology as much as possible, while getting the biggest bang for our buck.

We prefer taking a deep dive into interesting companies rather than pricing all companies all the time, which is a misallocation of scarce research resources, which is brings us back to our objective.

Price uncertainty and the real world

Models are what analysts use to forecast business outcomes, they can be complex or simple. Likewise, valuations are an approximation of the price we think the business is worth based on those forecasts, and they can be complex or simple too. There is no point building an overly complex model if a simple one will do well enough.

Whether it's a model car or a climate model, models are just an approximation of the real world. Models can be fine-tuned to make them more like the real world, but that comes at the cost of time, money and increased complexity, which also may make them more error prone. In the case of financial models, forecast uncertainties can add up. For companies that only have a small degree of mispricing, the pricing measurement uncertainties could be bigger than the potential upside pay-off.

Investors need to take these trade-offs into account when they value a business, and use them to their advantage. After all, the price of anything is only what some-one will pay for it.

About Monash Investors

In 2012, Monash Investors was established by one of Australia's most experienced fund managers in Simon Shields, the previous head of equities at both UBS and CFS, and Shane Fitzgerald a senior equity analyst from UBS and JPMorgan.

The firm was set up to manage money in a way that both Simon and Shane felt was simply smarter than riding the share market up and down, instead, attempting to achieve positive absolute returns of between 12-15% p.a. after fees, over a full investment cycle, and avoid loss in any financial year. (see our performance here).

Importantly, it was the experience gained across multiple investment styles and in seeing the pitfalls in managing very large pools of capital that shaped the way the Fund is managed today.

About the author

Simon Shields, Co Portfolio Manager and Founder
B.Com (Hons), LLB, MBA, CFA

Simon is one of Australia's leading fund managers with over 27 years of industry experience and most recently, having been Head of Australian Equities at both UBS Global Asset Management (Australia) Limited (UBS) and Colonial First State Limited (CFS). Simon has been a member of and/or led mulit-award winning equity teams across a range of investment styles.

He holds a Bachelor of Commerce with Honours, Bachelor of Law, Masters of Business Administration and is a Chartered Financial Analyst.

Simon commenced his career as an analyst with Westpac Investment Management Limited (now part of BT Investment Management Limited), before moving into a portfolio management role. In 1995, he moved to Rothschild Australia Asset Management Limited as a Portfolio Manager, responsible for value-style Australian equities. In March 1998, he joined CFS as a Senior Portfolio Manager, responsible for growth style Australian and New Zealand equities, before becoming the Head of Australian Equities in January 2004. In July 2007, he moved to UBS as Managing Director and Head of Australian Equities and in 2011 also took responsibility for the ING Investment Management Limited Australian equity team.

In 2011, the UBS Australian Share Fund, which was managed by Simon, received the 2012 Money Magazine award for the "Best of the Best".

Simon is a director and co-founder of Monash Investors. His role includes research, analysis, dealing and investment management of the Monash Absolute Investment Fund.

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