

LOS 34.a

2011 CFA® Exam

SS 10

Explain how the classic works on asset valuation by Graham and Dodd and John Burr Williams are reflected in modern techniques of equity valuation.

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LOS 34.a

- Graham and Dodd's fundamental contribution to modern security analysis was their insight that the analyst should estimate an investment's intrinsic value independent of its market price by multiplying earnings power by an appropriate capitalization factor. This is an early forerunner of the modern relative valuation models of today.
- The modern dividend discount and free cash flow models of today are based on Williams's basic insight that the value of any investment is the present value of its future cash flows, discounted at the opportunity cost of the capital necessary to make the investment.
- The contribution of modern portfolio theory to modern equity valuation models is the basic insight that return depends on the risk that the investor cannot diversify away (i.e., nondiversifiable risk).

LOS 35.a

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Define valuation and intrinsic value, and **explain** possible sources of perceived mispricing.

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Intrinsic value (IV) is the value of an asset or security estimated by someone who has complete understanding of the characteristics of the asset or issuing firm. To the extent that market prices are not perfectly (informationally) efficient, they may diverge from intrinsic value. The difference between the analyst's estimate of intrinsic value and the current price is made up of two components—the difference between the actual intrinsic value and the market price, and the difference between the actual intrinsic value and the analyst's estimate of intrinsic value:

$$IV_{\text{analyst}} - \text{price} = (IV_{\text{actual}} - \text{price}) + (IV_{\text{analyst}} - IV_{\text{actual}})$$

LOS 35.b

2011 CFA® Exam

SS 10

Explain the going concern assumption, **contrast** a going concern value to a liquidation value, and **identify** the definition of value most relevant to public company valuation.

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LOS 35.b

The **going concern assumption** is simply the assumption that a company will continue to operate as a business as opposed to going out of business. The **liquidation value** is the estimate of what the assets of the firm would bring if sold separately, net of the company's liabilities.

LOS 35.c

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Discuss the uses of equity valuation.

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Equity valuation is the process of estimating the value of an asset by (1) using a model based on the variables the analyst believes influence the fundamental value of the asset, or (2) comparing it to the observable market value of “similar” assets. Equity valuation models are used by analysts in a number of ways. Examples include stock selection, reading the market, projecting the value of corporate actions, fairness opinions, planning and consulting, communication with analysts and investors, valuation of private business, and portfolio management.



LOS 35.d

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Explain the elements of industry and competitive analysis and the importance of evaluating the quality of financial statement information.

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LOS 35.d

The five elements of industry structure as developed by Professor Michael Porter are:

1. Threat of new entrants in the industry.
2. Threat of substitutes.
3. Bargaining power of buyers.
4. Bargaining power of suppliers.
5. Rivalry among existing competitors.

Quality of earnings issues can be broken down into several categories and may be addressed only in the footnotes and disclosures to the financial statements:

- Accelerating or premature recognition of income.
- Reclassifying gains and nonoperating income.
- Expense recognition and losses.
- Amortization, depreciation, and discount rates.
- Off-balance-sheet issues.

LOS 35.e

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Contrast absolute and relative valuation models, and **describe** examples of each type of model.

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LOS 35.e

An **absolute valuation model** is one that estimates an asset's intrinsic value (e.g., the Discounted Dividend approach). **Relative valuation models** estimate an asset's investment characteristics compared to the value of other firms (e.g., comparing P/E ratios to those of other firms in the industry).

LOS 35.f

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SS 10

Illustrate the broad criteria for choosing an appropriate approach for valuing a given company.

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LOS 35.f

When selecting an approach for valuing a given company, an analyst should consider whether the model fits the characteristics of the company, is appropriate based on the quality and availability of input data, and is suitable given the purpose of the analysis.

LOS 36.a

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SS 10

Explain the historical differences in market organization.

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LOS 36.a

Most modern stock exchanges (or “bourses”) have their origins in one of three basic historical types: private bourses, public bourses, and bankers’ bourses.

1. **Private bourses** were established by individuals for the purpose of securities trading. They are privately owned, but publicly regulated with a strong bias towards self-regulation. Many of the private bourses today were directly influenced by and developed from the early British exchanges. This is the most popular model today.
2. **Public bourses** first developed in France during the early 1800s. Public bourses are public institutions with brokers appointed by the government. Public brokerage firms’ commissions and memberships are regulated by government officials. Most public bourses have converted to private bourses over the years.
3. **Bankers’ bourses** developed out of the German Banking Act which granted a brokerage monopoly to banks. In a bankers’ bourse, banks play the primary role in securities trading. Most bankers’ bourses had developed into private bourses by the 1990s.

LOS 36.b

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Differentiate between an order-driven market and a price-driven market, and **explain** the risks and advantages of each.

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LOS 36.b

Order-driven markets (also known as **auction markets**) do not have market makers. Instead, the auction market matches the supply and demand for securities directly. Order-driven markets function as electronic order-driven systems where all transactions flow through a computer. Prices are determined by the supply and demand for the securities. The central order book is the focus of the markets' operations.



A **price-driven market** (also known as a **dealer market** or **quote-driven market**) is a market in which market makers maintain an inventory of securities and continuously quote prices at which they will buy (the bid price) and sell (the ask price). Competition among the market makers promotes the best prices.

