How investment securities are valued -- snapshots in time

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Summary: Every securities market transaction requires a buyer and seller with differing viewpoints. Differences between investors in their assessments of the intrinsic value and risk of securities allow markets to operate. Investment values are in the eyes of the many beholders of investment securities. Knowledgeable participants in securities markets use a wide variety of methods, data, metrics, and information to assess the value and risks of particular securities. The viewpoints of market participants regarding any particular security can vary dramatically. One participant might view the current market price as a wonderful bargain, while another might think that the price is excessive. This disparity of viewpoints permits markets to operate. A fluctuating market pricing mechanism sets the current price within this range of conflicting opinions about value and risk. The market matches buyers and sellers to complete transactions and balance supply and demand at each point in time. Valuation involves both an assessment of the intrinsic value of a security and the likelihood that such value will be realized. The best that market participants can do is to incorporate two things into their valuation of that security: a) currently known information and b) their speculation about what might happen and how it would affect value in the future. Market participants must buy or sell at the current market price or remain inactive. Whether or not they act depends upon their assessment of value and risk versus the risk/return consensus that is reflected in the current market price. Generally, market traded equity and debt securities are legal claims to some aspect of the finances of a business or governmental entity. While potentially quite complex, the “easy” part of the analysis relates to assessing the underlying value of a security through financial modeling or whatever other valuation method an investor may use. Unfortunately, future-oriented financial models are deceptively straightforward. Forecasted numbers on paper have a tendency to seem more real than they actually are. Perhaps this is because they are often similar in format to the reporting of actual historical financial performance. However, forecasts on paper are simply rational fantasies about an unknowable future. Every investor, analyst, business planner, manager, and executive faces the same problems with the reliability of forecasting. The major problem with plans about the future is risk and whether this risk can be contained and managed. Risk assessment is the much harder part of securities valuation. A myriad of positive and negative factors could intervene as time goes on to create economic successes and failures. For those who attempt rationally to value a security, assigning a current risk-adjusted valuation requires predicting events that may or may not happen. This process gives rise to a substantial amount of uncertainty regarding any particular security. The further into the future an investor attempts to peer, the greater the uncertainty. The future is fundamentally unpredictable in any of its details. No investor has a working crystal ball. If you go for a cup of coffee, you expect to get it in a few minutes. The odds are strong that you will be savoring your coffee as you planned. However, there are no guarantees. Many things positive and negative could intervene to alter your quest for caffeine … the phone, the boss, etc. As with anything in life, business, and economics, no one knows what will happen with absolute certainty. Anyone can have a more or less informed opinion about what “may” happen to the value of a security. However, people do not and cannot “know” with any

certainty. This uncertainty of future asset values is why markets can and should be baffling to thoughtful individual investors and professionals. Anyone who predicts with an air of certainty what the securities markets will do or who does not offer a slew of caveats should simply be ignored. Uncertainty about future outcomes is the reason why investors over time tend to be paid a market risk premium return for investing their hard-earned money in risky assets. However, the scientific investment literature demonstrates that investors should avoid active strategies that bet on particular securities outcomes, because on average current market prices tend not to allow for profit in excess of the market return after investment costs, taxes, time, and risk are properly valued. Cumulatively, "lucky losses" just tend to outweigh "lucky gains." Amateur and professional investors need to recognize they cannot reliably place profitable active bets, because they simply do not know what will happen to future asset values relative to current values. All you can "know" is that investorsin the past have been positively compensated on average by the securities markets for exposing their assets to general market risks. If you "believe" that securities markets in the future will have similar characteristics, then you take a leap of faith and invest your assets in the markets now in proportion to your tolerance for risk. Since there is also no evidence that investors can consistently time market downturns and upturns, then you simply keep tolerable portions of your assets invested across time, unless you need them for expenses. You have to be in the market to capture the market premium when it occurs, and you have to take the bumps as they occur. There is not safety either in the market or on the sidelines. Markets are unsafe because the have unpredictable downturns. Staying on the sidelines is unsafe because the market premium is unpredictable and you will miss it when it happens. No potential pain no potential gain.

These related articles may also be useful to you:Securities Valuation: ->Introduction to investment valuation and securities risk ->The confusing investment securities market motion picture ->What is efficient market pricing in the securities markets? Returns and Risk Premiums: ->Asset class investment risk premiums -- your reward for taking investment risk ->How stable have common stock equity risk premiums been over time? ->What explains the recent common stock equity risk premium? ->How are asset class risk premiums and the risk free rate of return related? ->What might explain the dramatic rise in common stock equity prices during the 1980s and 1990s? -> How do individual investors’ recent portfolio return expectations compare to long-term historical common stock returns and equity risk premiums? ->To estimate the future common stock risk premium, how might individual investors extrapolate from the past? ->What common stock returns might individual investors expect going forward? ->What happens to the expected equity premium, when the common stock P/E ratio reverts toward historical norms?