Introduction to investment valuation and securities risk

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The securities markets provide an evolving consensus of the risk-adjusted value of particular securities. By understanding how the markets value securities, individual investors can chose more durable investment strategies Judging the potential usefulness of different investment strategies requires some understanding of what the public securities markets really do. This article discusses how the markets price financial securities from the standpoints of risk and return. This description generally characterizes the behavior of modern securities markets in industrialized countries around the world. Securities markets provide a continually adjusting balance of trading order supply and demand, wherein price changes enable this evolving balance. Important observations about securities markets from investment science are that: The aggregate market return consists of payouts plus capital gains or losses across all investors. The aggregate market return is the total possible return for publicly traded securities. Fundamentally, markets look forward. Participants attempt to peer into the murky and fundamentally unknowable spectrum of possible future events. ->Markets price securities on a risk-adjusted basis. Current securities prices are discounted versus their projected future values to reward certain kinds of risk taking. Prices differ from one security to another, because expected economic returns differ and because investors perceive greater or lesser certainty in the realization of those expected returns. ->Current market prices reflect the current consensus or balance of expected risk and expected return. This valuation consensus reflects the balance across all active participants, including those who are paying attention, but chose not to act. ->Current market prices tend to reflect fully all currently known information associated with a particular security. There may be a wide range in the interpretation of the importance of various information, and asset market values reflect the consensus across all investors. ->New information disseminates widely and very rapidly. Investors quickly interpret new information for its potential impact upon both value and risk. Prices rapidly reflect new information, as supply and demand shifts quickly and market prices change accordingly. ->When some investors “win,” others must “lose” relative to the aggregate market return. Whether luck or skill determines who wins or loses and how one can tell the difference are pivotal questions in choosing investment strategies. By understanding these critical investment subjects and being aware of the associated scientific evidence, investors can adopt investment strategies that are potentially more profitable. Scientific evidence indicating which strategies are preferable reduces confusion and reinforces the confidence needed to ride out market volatility. Value fluctuations and conflicting opinions can challenge anyone to formulate and stick with a set of investment principles. Market fluctuations over time and across business cycles, industries, asset classes, geographies, etc. can raise significant doubts. The maelstrom of media and commentator truth, noise, and rubbish increases investor confusion. This very volatility and conflict of opinion requires investors to strive for an objective basis for choosing their investment strategies. The Skilled Investor can help individual investors to understand some of the important “whys” of investing. Many investors want to jump immediately to investment tactics and may avoid thinking more deeply about the underlying logic or validity of those tactics. Shooting prior to aiming generally leads to poor results.

Given the astonishing amount of erroneous investment information and fallacious theories circulating, tactical action without a scientific anchor can be hard on your wallet. (See: How can individual investors trust, when so much investment information is rubbish?)

These related articles may also be useful to you:Securities Valuation: ->How investment securities are valued -- snapshots in time ->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?