

Why The Share Price Is Not Always Right

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With share markets around the world falling some 60% off their highs, investors feel anxious. However, what we need to do is separate the underlying value in a business (and assets) and the price that a share of this business is trading for on the stock market.

My father is going to hate me saying this, but unfortunately I can forget the first two weeks of Applied Finance at University where they told us that markets are efficient and all information is reflected in the share price (thereby making opportunity impossible). With all due respect to my lecturer, I can say this premise is rubbish and it relies on one big assumption that all investors will act rationally. Now if anyone knows anyone that acts rationally 100% of the time I would be surprised, to say the least. It is even more unlikely that people will act rationally when fear and greed come into the equation. This emotion is as powerful as any other human emotion including love.....and to quote an old saying "love make us do silly things".

To demonstrate an example of how the share price can not represent the underlying value of the business, I will use the example of the best performing company in the 1990s Microsoft. An outstanding company with strong brands and dominant market position and the only company in the S&P 500 to grow profits by greater than 30% every year throughout the decade (refer to the redline in the top graph on the diagram below). A great business as the profit grows at a steady rate.

However, as you can see the market capitalisation which is a measurement for how the stock market is pricing the company is far more dramatic (blue line on bottom graph). The market capitalisation is the value the share market attributes to this business by taking the number of shares on issue and multiplying by current share price. If someone was going to buy 100% of this



company they would need to pay this price to acquire it off existing shareholders.

You can see that from the period of 1995 to 2000 the market capitalisation (value attributed by share market) of Microsoft went from \$50 Billion to a staggering \$600 Billion. However please note in 1995 the net income (profit) was approx \$3 Billion and in 2000 it was approx \$8 Billion.

Now, as a rational investor in 1995, if we were willing to pay \$50 Billion for \$3 Billion per annum in profits this means that we are willing to pay 17 times earnings (long term sharemarket average is about 15 times earnings but you pay a bit more for a great business). Therefore applying the same logic in the year 2000 when Microsoft earned \$8 Billion in profit for the year a rational investor would be willing to pay \$136 Billion for the company. This is quite a large divergence from the value attributed to Microsoft by the share market which valued it at \$600 Billion. This divergence was caused by the euphoria of the internet and tech boom, and this lasted several years. For a number of years an investment in Microsoft looked like a fantastic investment when the share price got to well in excess of \$100 but once reality hit home and the euphoria broke the share price fell down by about 90%. We can buy Microsoft shares today for \$19. This also reinforces that the measurement of success or otherwise of any investment strategy needs to be based on sound fundamentals (not share price performance) and over long periods of time...in the tech boom 5 years was a short period of time.

This is where we need to draw on an important distinction about investing.

Investing is about buying good assets but also paying the right price (or preferably less) for those assets.

What we are seeing at the moment is a market driven by fear which is the opposite of the case study I used with Microsoft however the lessons are the same....just on the reverse. What we have at the moment is good businesses and assets trading at far less than what they are worth because in the same way greed distorted peoples view on Microsoft fear is now the dominant theme in markets.

As with the Microsoft example measuring investment success or otherwise by share price movements is not sound fundamentally what is more important is understanding the assets or business you own and the long term value they will provide in the forms of growing profits, rental streams or income distributions.