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Critical Perspectives on Accounting

journal homepage: www.elsevier.com/locate/cpa



Value without valuation? An example of the cocos market

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ARTICLE INFO

Article history:

Received 31 July 2014

Received in revised form 7 April 2016

Accepted 19 June 2016

Available online xxx

Keywords:

Financial markets

Valuation

Contingent convertible bonds

Financial risk communication

ABSTRACT

In this paper, I suggest that financial products simultaneously inhabit two regimes of valuation: calculative and consumptive. There are constant endeavors in the market to develop formal mathematical methods of valuation and to use them as a base for investment decisions. Using the example of contingent convertible bonds (“cocos”), I argue that our understanding of how financial markets function would remain limited if we were to focus only on those formal endeavors. In the case of cocos, stringent mathematical valuation is impossible due to the contingent nature of this product and many future uncertainties. Based on various empirical materials, I demonstrate that the lack of established valuation tools is complemented and compensated by the purposeful efforts to sell this product. Cocos are *categorized* as simple bonds in order to be sold; they are associated with *brands*; their *risks are marketed* in a particular way. This *consumptive regime of valuation* allows for determining value and investing where formal mathematical valuation is deferred. Thus, incorporating the insight that *marketing constitutes markets*, the paper sheds light on how financial markets function, and amends the purely calculative perspective of mainstream finance. Furthermore, the paper relates *consumptive finance* to major issues in critical finance, such as power and governance, risk ignorance and financial illiteracy. More generally, it argues that active selling efforts represent a severe research gap in critical and social studies of finance and should be more clearly outlined and developed.

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1. Introduction

How can we explain and describe the valuation process of a new financial product? I would like to discuss this question using the example of “cocos” (the contingent convertible bonds). As a new financial asset, they appeared on the radar screen of investors in the aftermath of the financial crisis of 2007–2009. In an effort to create a more stable banking system, regulators allowed banks to issue hybrid capital securities which can absorb bank losses and create fresh equity capital in a situation of financial distress: if particular negative events happen, for example, if the capital ratio of the bank falls below the specified minimal level or if the share price breaches a pre-set requirement, the cocos can be converted into equities or written down partly or completely. As a compensation for these risks, the buyers of cocos receive a very attractive coupon (usually between 7% and 9%).

As mainstream finance considers valuation to be based on modeling and calculations, it faces a problem in the case of cocos: the mathematically stringent valuation of those products is difficult to impossible due to their contingent nature: It remains unclear if they should be valued as bonds, equities or derivatives. Furthermore, the cocos' valuation is based on too many future uncertainties which cannot be easily resolved (the more detailed discussion follows in Section 3). As a result,

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<http://dx.doi.org/10.1016/j.cpa.2016.06.006>

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this new product represents a puzzle for mainstream finance: Cocos apparently possess value because there is a functioning market for them; at the same time, this value cannot be approached by means of mathematics; thus, from the textbook finance perspective, we are confronted with *value without valuation*. Should rational market participants not refuse to trade and to exchange the asset whose value they do not know? Should the market for this asset not cease to exist at all?

Obviously not. The market for cocos has been prospering recently. In 2013, “European issuance exceeded \$14.3 bn [. . .] and is close to \$10bn already this year” (Atkins, 2014: 24); the total issuance is likely to reach €100 bn by year-end 2014 (Gallo, 2014). The cocos issues are usually oversubscribed. The most recent example is Deutsche Bank, which “attracted an astounding €25bn worth of orders” for its cocos issue and ultimately increased the size of the offering from €1.5 bn to €3.5 bn: “Yield-starved investors are clearly cuckoo for coco puffs” (Alloway, 2014). Thus, apparently, investments in cocos are possible (and flourishing) even if the strict *calculative regime of valuation* is deferred. How can we approach this puzzle?

Critical finance studies might provide some help. This field of inquiry (Bay & Schninckus, 2012; Forslund & Bay, 2009) offers conceptual and methodological tools to formulate and to solve problems which mainstream finance – as a “house without windows” (Keasey & Hudson, 2007) – ignores or is not capable to solve. In the particular case of the cocos’ valuation puzzle, critical studies of finance, first, suggest an alternative concept of valuation and, second, allow for using qualitative methods of empirical research to substantiate and to develop this concept (Bettner, Robinson, & McGoun, 1994; Frankfurter et al., 1994). In this perspective, valuation is not understood as a formal science or a calculative exercise but as a discursive practice and a human endeavor. Furthermore, the practice of valuation is contextualized within society, markets and organizations so that the focus is shifted towards the interconnection between the technical and social aspects of valuation. Now, “valuation and calculation at the margins” – understood as valuation and calculation “at different points in time and in different places” (Mennicken & Sjögren, 2015) – gain a particular interest. This local focus on the specific valuation practices is not a part of the mainstream finance that rather treats valuation in a very wholesale way.

In this paper, I follow the critical finance approach that has been developed so far. For example, Coleman (2014), in the first step, identifies a puzzle in the intellectual edifice of mainstream finance (Why do investment professionals not use classical finance theory?) and, then, drawing on the critical finance literature and using qualitative empirical materials, offers an explanation. In this paper, I proceed in the same vein. First, I pose a question of how cocos investors cope with the impossibility of precise mathematical valuation so that the market of this product continues its successful functioning. Then, I suggest how to install some “windows” and “doors” into mainstream finance’s house by considering valuation concepts that have been developed in critical finance so far and have gone beyond formal calculations (Section 2). I also draw on the results of the qualitative empirical study I conducted in the EU project “Evaluation practices in financial markets” (EPIFM) (I describe my data in Section 4).

After demonstrating why the precise formal valuation of cocos is not possible (Section 3), I suggest that we focus on the *consumptive regime of valuation*. By doing so, I shift the focus from *efforts to calculate* to *efforts to sell* (Section 5). Selling is an important factor in producing market participants’ willingness to invest – allowing markets to recognize value and to flourish even if the formal valuation is deferred. Introduction of marketing as an additional regime of valuation sheds light on how financial markets function, emphasizing an important – and previously neglected – element of this functioning.

Indeed, selling is not a well-recognized topic in critical and social studies of finance. There are individual voices that start to point to this severe gap (Harrington, 2010; Lépinay, 2011; McFall, 2011a,b; Roscoe, 2013; Vargha, 2011): It should be recognized that marketing – among other factors – constitutes markets. The paper at hand would like to tune into this discussion and to empirically develop a case that demonstrates how particular ways of selling cocos enable the very existence of a market for this instrument. In a nutshell, the paper shows how cocos (which are “high yield – high risk” products) are constituted as “high yield – low risk” investment objects in the process of selling. Thus, the demand for cocos develops not because a formal model judges them as “cheap” but because they are presented (made perceivable as) products that guarantee high return for low risk.

Subsequently, in Section 6, the findings are related to the critical finance debate about goals and means of finance, “governance”, “strategic ignorance” and financial illiteracy (Davies & McGoey, 2012; Forslund & Bay, 2009; Gigerenzer, 2015).

Generally, the article suggests that *the active efforts to sell* should be more clearly outlined as an issue of finance. This study aims to explicitly initiate and support this discussion.

2. Overview of the critical literature on valuation

One of the most persistent puzzles in finance is the puzzle of valuation. How do we determine what a financial asset costs? Famously, mainstream finance believes that at the core of asset pricing and asset valuation is the calculation of “real”, “fair”, “intrinsic” or “fundamental” value. This is supposed to be a correct, or true, value based on macro and micro “fundamentals”. In order to make investment decisions, market participants determine the value of the product, i.e., estimate what the asset is worth today and how much they are ready to pay for this asset. Price, or what an investor *effectively pays* when buying a security, might deviate from the intrinsic value but always fluctuates around it (Koller, Goedhart, and Wessels, 2010: 337). Thus, according to mainstream finance, if one can determine the value, he or she knows the direction and magnitude of the future price movement, as prices are supposed to move towards value (in completely efficient markets, price equals value). Hence, the pursuit of the valuation approach that provides investors with the precise mathematical calculation of the value became the very matter of financial theory and financial modeling.

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