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Procedia Economics and Finance 25 (2015) 220 – 226

Procedia Economics and Finance

www.elsevier.com/locate/procedia

16th Annual Conference on Finance and Accounting, ACFA Prague 2015, 29th May 2015

The Relationship between Discounts and Premiums and Value Investing Theory

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Abstract

The aim of this topic is to provide a different view on the theory of value investing through exploration of discounts and premiums. Method of discounts and premiums comes from the field of business valuation and answers the question, why the price of certain stock is overvalued or undervalued compared in contrast with an average. The first chapter of this thesis deals with general issues of value investing and method of choosing appropriate shares. The next section presents a theory of discounts and premiums. The last chapter tests a sample of stocks selected on the basis of the value investment approach and surveys that sample of stocks by the approach of discounts and premiums.

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Peer-review under responsibility of University of Economics, Prague, Faculty of Finance and Accounting

Keywords: Discount; Premium; Value investing; stock

1. Introduction

The value investment theory is often associated with famous names like Graham, Dodd, and Warren Buffet. The aim is to find fundamentally strong shares whose intrinsic value exceeds the current market price. Investors try to create so called “margin of safety” to minimize any decline in market prices of shares. Value investors look for stocks which stand out of the investor’s interest and are relatively "cheap" (Benjamin Graham, 2008). The aim of this paper is to highlight the possible shortcomings of this theory, through the method of discounts and premiums.

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Peer-review under responsibility of University of Economics, Prague, Faculty of Finance and Accounting
doi:10.1016/S2212-5671(15)00732-7

This method is used in business valuation and takes into account specific factors affecting stock prices (Mařík, 2007).There is a possibility that a relatively low share price is caused by very specific factors that are not primarily visible. The answer to this question should provide the theory of discounts and premiums. (Kábrt, 2014)

2. Value investing

Now I'll introduce one of many approaches used by investors to the selection of appropriate shares. The aim of value philosophy is simply a selection of fundamentally strong shares, with an emphasis on creating a sufficient "margin of safety" against a possible decline in their prices. This approach considers the rise in share prices as a bonus (Buffett, 1961). The main goal of value investor is to maximize a security of portfolio against potential losses. In contrast with „growth philosophy“, which prefers the current "popular" and rapidly growing shares, value approach tries to identify stocks whose profits are currently rather disappointing for investors, or behind the interest of investors. (Benjamin Graham, 2008)

2.1. Margin of safety

This simple concept, introduced by Benjamin Graham in his book The Intelligent Investor (Graham, 2007) represents a key element in selection of appropriate shares. The margin of safety is certain percentage (discount) with which the share is bought in contrast with its intrinsic value. E.g. intrinsic value of the shares of YHOO (Yahoo) will be $ 40 apiece and investor will be willing to buy it for $ 30 apiece. Its "margin of safety" will therefore be 25%.
If this value is high or low depends on the specific nature of investor’s behaviour (Daniel Kahneman A. T., 1979). This concept leads to the following conclusions:

- It is not easy to determine an intrinsic value of shares - thus, if we make a mistake in calculation, sufficient "margin of safety" will protect us against our failure.
- Intrinsic value of share is variable in time and its value unexpectedly reacts to external events, thus higher "margin of safety" enable us to respond with greater delay to unexpected market fluctuations.
- The higher the "margin of safety", the higher the probability of success of an investment (if you buy 1 crown for 50 cents is more likely to earn than if the same crown buy for 90 cents).
- The higher the required "margin of safety", the more difficult to find relevant investment titles (Graham, 2007)

2.2. Value screening

Value screening is a screening method for selecting stocks according to the Value investing theory (Veselá, Investování na kapitálových trzích, 2011). In this section, we present a simple filter, consisting of six main elements that should secure high probability of selecting fundamentally strong shares. If shares pass through our filter, there is a high probability that they fulfil our requirement on high margin of safety. (Benjamin Graham, 2008)

Required criteria:

- P/E < 15 (Price to earnings ratio)
- P/BV < 1.5 (Price to book value)
- Dividend yield > 0
- Current ratio > 2
- Earnings per share (in last 5 years) > 0
- Debt/equity < 0.6
- Market capitalization > 500 mil. USD

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