Fair Value and the Guide Maps of Investing: Seeking Better Metric for Market Valuation

Vinay Paharia, Chief Investment Officer of Union Asset Management Company Private Limited, the Investment Manager to Union Mutual Fund, believes that we must all become smarter at reading the signs that point us towards value in the equity markets. He presented a lively and informative Workshop at the India Wealth Management Forum to explain his views on the fallacy of the index PE multiple, the strengths of the fair value approach to investing, and how to better map, plan and time market activity.

PAHARIA BEGAN BY EXPLAINING THE IMPACT OF the index PE multiple and its impact on the market and said he would then move on to the fair value approach. He said that market participants are continually bombarded with a variety of market valuation metrics, from many sources including the local and global media. He noted that the index PE multiple approach is very popular with investors to gauge the temperature of the market, with a historical perspective indicating whether the market is cheap or expensive.

"But as we all know, corporate earnings, as measured by index EPS, have hardly grown in the past seven years (i.e., from March 2012 to March 2019)," he remarked. "As the stock market has delivered very strong returns during a similar period, the PE multiple of the market has risen. So, this index PE approach can be rather an illusion and can lead to wrong conclusions."

And with that he offered a hypothetical example of a market with just two stocks, rather than 50 for the NIFTY 50, for example, or 500 for the BSE500. One stock is a bank which is normally trading in the market at a roughly 10x PE multiple and a FMCG [fast-moving consumer goods] company, a typical high valuation flag bearer, that trades at around 50 times.

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The bank has profits of 50 and a valuation of 500. The FMCG business profits of 10 and a valuation of 500. In Scenario 1 in year 1, the bank profits are flat, the FMCG profits rise by 50%, so the total market value is now 500 for the bank and 750 for the FMCG stock. In this scenario the index earnings have risen by 8% from 60 to 65, but the index value has gone up by 25% from 1000 to 1250.

"In this picture, the PE multiple for the index goes up by about 15% and it is a very common conclusion for most people to say that the index has become expensive," he observed.

He then offered another example in which the reverse happens, with the FMCG stock flat and the bank profits up 50%. Here, the index profits have gone up by 42% and the index value has gone up by 25%.

"In this scenario, many would presume the index has become cheaper, but this may not be true," Paharia commented.

"Now, let's assume the bank's Fair Value should be only 9x profits and the FMCG stock should trade at 55 times profits to be fairly valued. Thus, when the bank trades at 10x, its actually expensive, while when FMCG company stock trades at 50x, it is cheap based on the Fair Value Approach. Then, in Scenario 1, by applying the fair value approach, we arrive at a conclusion that the index has actually turned cheaper. This is intuitively consistent as a cheaper company in the index, i.e. the FMCG stock which trades at 50x versus a fair value of 55x - is now a bigger constituent of the index, and hence overall index should have become cheaper."

"In short," Paharia explained, "the Index PE Multiple can distort the facts and can be highly misleading, whereas fair value correctly conveys the true valuation of an Index. And now we can relate this to what has happened in the last six to seven years in India. Over the last seven years, we have seen the NIFTY EPS compound at about 10.3%, but the NIFTY index compounded at about 14%, and fair value compounded at about 13.9%. The market is far more efficient than lot of us think."

He then highlighted how the index today is very different from

the index of seven or more years ago. Also, subsidiaries of large companies may not generate reported profit, but at the same time may be very significant contributors to their overall market value. "All these factors," he concluded, "can create an illusion that the index has become expensive. This was the case from 2012 to 2019 period and the reverse is expected to happen in the next three years, as the NIFTY earnings are expected to surge. But if the earnings are growing rapidly driven by low PE businesses, then the fair PE multiple for the index should also fall."

Paharia defined Fair Value as a simple multiple of core earnings or core book with a Fair Value multiple. Fair Value multiple is driven by four factors - returns on equity, earnings growth, the risk-free rate of return and the riskiness of the underlying business.

"In a growth company," he explained, "Fair Value compounds at a fast pace and typically, the market price of such companies is at a premium to current fair value, so future potential returns depend on current market price and future fair value, hence future fair value growth is key driver of stock returns. Whereas in a bargain stock, Fair Value compounds at a slow pace, typically the market price of such companies is at a discount to current fair value and so future potential returns depend on current market price and future fair value, hence future re-rating is the key driver of those stock returns."

And he noted that the value trap must be avoided, as the acid test of a value trap is the decline in Fair Value over time.

"To summarise," Paharia concluded, "Index PE multiples can distort the facts and the fair value approach helps you understand what the true valuation of that index or market is. It is like the Guide Maps of investing, which as we all know tell us the time to reach the destination, the best route and also updates you on the route in real time. The same is the case with fair value, it helps me to analyse my potential returns if I invest in a basket portfolio of securities, it tells me the optimal portfolio and it alerts me of changes on a real time basis."

Paharia spent the latter portion of the Workshop mining down into considerable further detail on the analytical approach that his company takes to the theories of valuation and investment they advocate, leaving the audience both fascinated and deeply informed. ■