

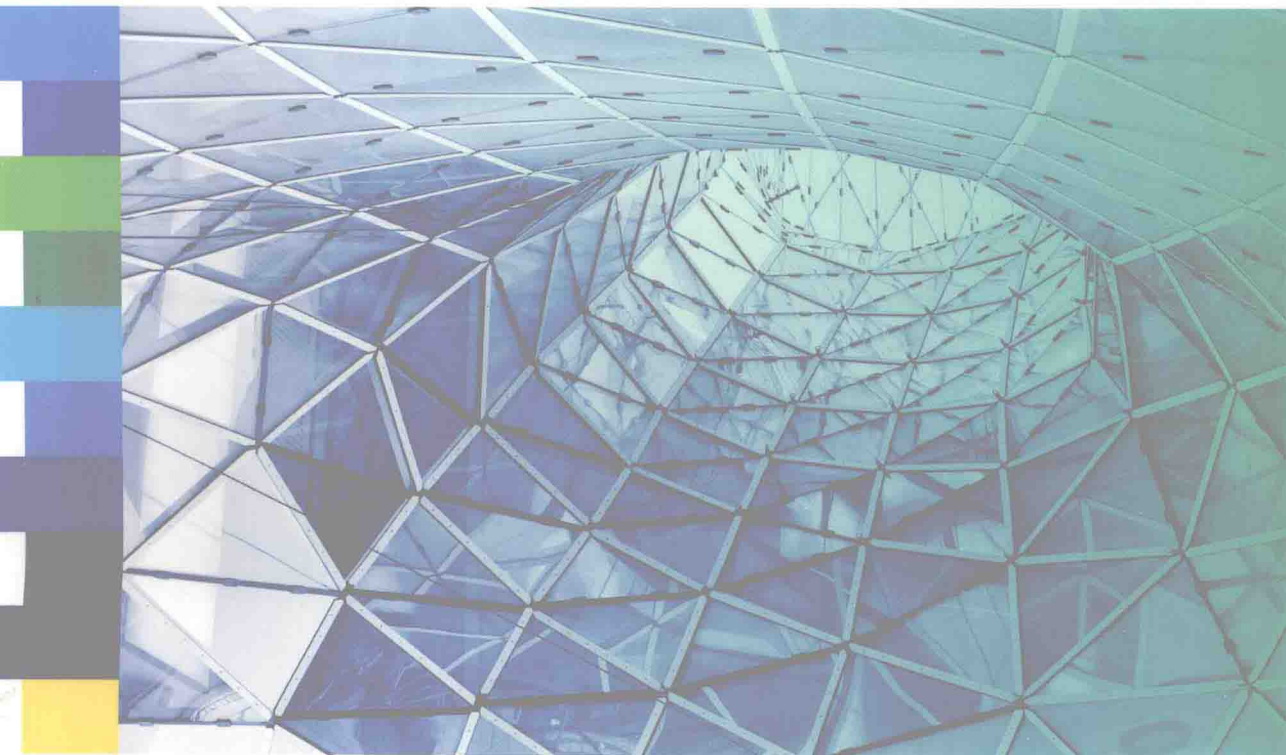


CFA Institute

CFA INSTITUTE INVESTMENT SERIES

EQUITY ASSET VALUATION

Third Edition



Jerald E. Pinto, CFA ■ **Elaine Henry, CFA**
Thomas R. Robinson, CFA ■ **John D. Stowe, CFA**

Foreword by Paul F. Miller, Jr., CFA

EQUITY ASSET VALUATION

Third Edition

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with

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WILEY

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EQUITY ASSET VALUATION

CFA Institute is the premier association for investment professionals around the world, with over 130,000 members in 151 countries and territories. Since 1963 the organization has developed and administered the renowned Chartered Financial Analyst® Program. With a rich history of leading the investment profession, CFA Institute has set the highest standards in ethics, education, and professional excellence within the global investment community and is the foremost authority on investment profession conduct and practice. Each book in the CFA Institute Investment Series is geared toward industry practitioners along with graduate-level finance students and covers the most important topics in the industry. The authors of these cutting-edge books are themselves industry professionals and academics and bring their wealth of knowledge and expertise to this series.

FOREWORD

Security analysis, for whatever purpose, is incomplete without a valuation of the asset being analyzed. So, studying the economics and finances of a business is simply preparation for that valuation.

When I entered the investment business in 1952, I was handed the task of analyzing and valuing about a dozen common stocks. My business school education had prepared me to analyze the economics and finances of a business, but it came up short on the elements of valuation techniques.

In those days, valuation thinking was still influenced by the Great Depression. Ridiculous as it may sound today, we tried to estimate what a company's earnings might be in the event of a recession in GDP in the range of 10 to 15 percent, with the next step being placing a multiplier on those depressed earnings. The result was what we called "sound value." Of course, the resulting values did not materialize in the bull market of the following years.

The art of security analysis has evolved significantly since then. What fascinates me is how and why the valuation techniques have evolved. The main cause, in my opinion, lies in the accumulating evidence that U.S. and world economies have become significantly more resilient to major declines. Today, for economically sensitive businesses, valuations tend to use normalizing techniques rather than attempting to estimate cyclical peaks and troughs.

The valuation methods explored in this book can be applied by different types of investors, in different market environments, and for different types of transactions. When reading Wall Street research reports or listening to financial TV programs, it is rare to see or hear a well-designed valuation. Usually, the valuation process consists of attaching an earnings multiple to an estimated earnings growth rate. This book provides an excellent review of the fundamentals and techniques used to value equity assets.

No single valuation technique suits all investors in all types of transactions, and this book adequately recognizes that fact. No matter your level of financial sophistication, you can benefit from reading it.

Paul F. Miller, Jr., CFA

PREFACE

We are pleased to bring you *Equity Asset Valuation, Third Edition*. We believe this book serves as a particularly important resource for anyone involved in estimating the value of securities and understanding security pricing.

The content was developed in partnership by a team of distinguished academics and practitioners, chosen for their acknowledged expertise in the field, and guided by CFA Institute. It is written specifically with the investment practitioner in mind and is replete with examples and practice problems that reinforce the learning outcomes and demonstrate real-world applicability.

The CFA Program Curriculum, from which the content of this book was drawn, is subjected to a rigorous review process to assure that it is:

- Faithful to the findings of our ongoing industry practice analysis
- Valuable to members, employers, and investors
- Globally relevant
- Generalist (as opposed to specialist) in nature
- Replete with sufficient examples and practice opportunities
- Pedagogically sound

The accompanying workbook is a useful reference that provides Learning Outcome Statements, which describe exactly what readers will learn and be able to demonstrate after mastering the accompanying material. Additionally, the workbook has summary overviews and practice problems for each chapter.

We hope you will find this and other books in the CFA Institute Investment Series helpful in your efforts to grow your investment knowledge, whether you are a relatively new entrant or an experienced veteran striving to keep up to date in the ever-changing market environment. CFA Institute, as a long-term committed participant in the investment profession and a not-for-profit global membership association, is pleased to provide you with this opportunity.

THE CFA PROGRAM

If the subject matter of this book interests you and you are not already a CFA Charterholder, we hope you will consider registering for the CFA Program and starting progress toward earning the Chartered Financial Analyst designation. The CFA designation is a globally recognized standard of excellence for measuring the competence and integrity of investment professionals. To earn the CFA charter, candidates must successfully complete the CFA Program, a global graduate-level self-study program that combines a broad curriculum with professional conduct requirements as preparation for a career as an investment professional.

Anchored by a practice-based curriculum, the CFA Program Body of Knowledge reflects the knowledge, skills, and abilities identified by professionals as essential to the investment decision-making process. This body of knowledge maintains its relevance through a regular, extensive survey of practicing CFA charterholders across the globe. The curriculum covers 10 general topic areas, ranging from equity and fixed-income analysis to portfolio management to corporate finance—all with a heavy emphasis on the application of ethics in professional practice. Known for its rigor and breadth, the CFA Program curriculum highlights principles common to every market so that professionals who earn the CFA designation have a thoroughly global investment perspective and a profound understanding of the global marketplace.

CFA INSTITUTE

CFA Institute is the premier association for investment professionals around the world, with over 130,000 members in 151 countries and territories. Since 1963, the organization has developed and administered the renowned Chartered Financial Analyst® Program. With a rich history of leading the investment profession, CFA Institute has set the highest standards in ethics, education, and professional excellence within the global investment community and is the foremost authority on investment profession conduct and practice. Each book in the CFA Institute Investment Series is geared toward industry practitioners along with graduate-level finance students and covers the most important topics in the industry.

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We are indebted to Stephen E. Wilcox, CFA, for his work in updating the in-text self-test examples for all but three chapters of this book. His contribution was essential to the fresh look of this third edition.

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Finally, we are honored that Paul F. Miller, Jr., CFA, agreed to provide this book with a foreword.

ABOUT THE CFA INSTITUTE INVESTMENT SERIES

CFA Institute is pleased to provide you with the CFA Institute Investment Series, which covers major areas in the field of investments. We provide this best-in-class series for the same reason we have been chartering investment professionals for more than 50 years: to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence.

The books in the CFA Institute Investment Series contain practical, globally relevant material. They are intended both for those contemplating entry into the extremely competitive field of investment management as well as for those seeking a means of keeping their knowledge fresh and up to date. This series was designed to be user friendly and highly relevant.

We hope you find this series helpful in your efforts to grow your investment knowledge, whether you are a relatively new entrant or an experienced veteran ethically bound to keep up to date in the ever-changing market environment. As a long-term, committed participant in the investment profession and a not-for-profit global membership association, CFA Institute is pleased to provide you with this opportunity.

THE TEXTS

Corporate Finance: A Practical Approach is a solid foundation for those looking to achieve lasting business growth. In today's competitive business environment, companies must find innovative ways to enable rapid and sustainable growth. This text equips readers with the foundational knowledge and tools for making smart business decisions and formulating strategies to maximize company value. It covers everything from managing relationships between stakeholders to evaluating merger and acquisition bids, as well as the companies behind them. Through extensive use of real-world examples, readers will gain critical perspective into interpreting corporate financial data, evaluating projects, and allocating funds in ways that increase corporate value. Readers will gain insights into the tools and strategies used in modern corporate financial management.

Fixed Income Analysis has been at the forefront of new concepts in recent years, and this particular text offers some of the most recent material for the seasoned professional who is not a fixed-income specialist. The application of option and derivative technology to the once staid province of fixed income has helped contribute to an explosion of thought in this area. Professionals have been challenged to stay up to speed with credit derivatives, swaptions, collateralized mortgage securities, mortgage-backed securities, and other vehicles, and this explosion of products has strained the world's financial markets and tested central banks to provide

sufficient oversight. Armed with a thorough grasp of the new exposures, the professional investor is much better able to anticipate and understand the challenges our central bankers and markets face.

International Financial Statement Analysis is designed to address the ever-increasing need for investment professionals and students to think about financial statement analysis from a global perspective. The text is a practically oriented introduction to financial statement analysis that is distinguished by its combination of a true international orientation, a structured presentation style, and abundant illustrations and tools covering concepts as they are introduced in the text. The authors cover this discipline comprehensively and with an eye to ensuring the reader's success at all levels in the complex world of financial statement analysis.

Investments: Principles of Portfolio and Equity Analysis provides an accessible yet rigorous introduction to portfolio and equity analysis. Portfolio planning and portfolio management are presented within a context of up-to-date, global coverage of security markets, trading, and market-related concepts and products. The essentials of equity analysis and valuation are explained in detail and profusely illustrated. The book includes coverage of practitioner-important but often neglected topics, such as industry analysis. Throughout, the focus is on the practical application of key concepts with examples drawn from both emerging and developed markets. Each chapter affords the reader many opportunities to self-check his or her understanding of topics.

One of the most prominent texts over the years in the investment management industry has been Maginn and Tuttle's *Managing Investment Portfolios: A Dynamic Process*. The third edition updates key concepts from the 1990 second edition. Some of the more experienced members of our community own the prior two editions and will add the third edition to their libraries. Not only does this seminal work take the concepts from the other readings and put them in a portfolio context, but it also updates the concepts of alternative investments, performance presentation standards, portfolio execution, and, very importantly, individual investor portfolio management. Focusing attention away from institutional portfolios and toward the individual investor makes this edition an important and timely work.

Quantitative Investment Analysis focuses on some key tools that are needed by today's professional investor. In addition to classic time value of money, discounted cash flow applications, and probability material, there are two aspects that can be of value over traditional thinking.

The New Wealth Management: The Financial Advisor's Guide to Managing and Investing Client Assets is an updated version of Harold Evensky's mainstay reference guide for wealth managers. Harold Evensky, Stephen Horan, and Thomas Robinson have updated the core text of the 1997 first edition and added an abundance of new material to fully reflect today's investment challenges. The text provides authoritative coverage across the full spectrum of wealth management and serves as a comprehensive guide for financial advisors. The book expertly blends investment theory and real-world applications and is written in the same thorough but highly accessible style as the first edition. The first involves the chapters dealing with correlation and regression that ultimately figure into the formation of hypotheses for purposes of testing. This gets to a critical skill that challenges many professionals: the ability to distinguish useful information from the overwhelming quantity of available data. Second, the final chapter of *Quantitative Investment Analysis* covers portfolio concepts and takes the reader beyond the

traditional capital asset pricing model (CAPM) type of tools and into the more practical world of multifactor models and arbitrage pricing theory.

All books in the CFA Institute Investment Series are available through all major book-sellers. And, all titles are available on the Wiley Custom Select platform at <http://customselect.wiley.com/> where individual chapters for all the books may be mixed and matched to create custom textbooks for the classroom.

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