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## Insider: The challenge of value investing

12 February 2012 by John Looby



Warren Buffett: refuses to use high discount rates to compensate for risk. Photo: Bloomberg

**The choice of a discount rate to assess the value of an asset is a challenge for every investor. It is the crucial prerequisite to deciding whether or not an asset should be bought, and is used in conjunction with a reasonable assessment of the likely, sustainable earnings flow at the current price.**

The father of value investing, Ben Graham, chose a simple formula that incorporated his assessment of the sustainable earnings of the asset in question, the likely growth of these earnings and the yield offered by the 30-year AAA corporate bond index.

The approach of his most famous and most successful student, Warren Buffett, is even simpler and was summarised well in this quote from his letter to the shareholders of Berkshire Hathaway in 1998: "We don't discount the future cash flows at 9 per cent or 10 per cent; we use the US treasury rate. We try to deal with things about which we are quite certain. You can't compensate for risk by using a high discount rate."

Adherents of the efficient markets hypotheses (EMH) and its logical extension, the capital asset pricing model (CAPM), have dominated both academia and trading rooms in recent decades. They approach this issue with a formula which looks to incorporate a 'risk-free' rate and an 'equity risk premium' (ERP):

discount rate = risk-free rate + ERP.

While there are many points of debate about each of these approaches and their many variations, the key point of relevance here is that they all implicitly or explicitly incorporate the use of an 'interest rate' believed to be (or close to being) 'risk-free'.

The choice of discount rate is an essential and unavoidable decision in the valuing of an asset. Everything else being equal, the higher the rate, the lower the value and vice versa. A key ingredient in the calculation of an 'appropriate' discount rate is the rate on offer from a broadly 'risk-free' alternative. Once again, the lower this rate is assumed to be on a sustainable basis, the higher the value, and vice versa.

Interest rates and broad 'risk-free' yields have been on a generally declining trend since 1981, and are currently at lows not seen in over 50 years.

So how credible or sustainable is the continued use by many investors of a discount rate of 8 per cent or higher - which incorporates a 'risk-free rate' assumed to be 5 per cent to 6 per cent - in an era when interest rates and bond yields are at multi-decade lows and have been in structural decline since Reagan first won the White House (see graph).

While debate rages loudly about the sustainability of such historically low interest rates and bond yields, there are at least two strong arguments for believing that no significant reversal of this trend is on the horizon.

Having cut the price of short-term money to almost zero and bought substantial quantities of treasury bonds, the Federal Reserve is now all but impotent in determining the money supply. Many believe that, contrary to the views of Milton Friedman and his most famous student, Ben Bernanke, the continuing lack of demand for credit renders the Fed effectively powerless to reverse meaningfully the deleveraging forces dominating the economy or the current level of bond yields.

If such a statement sounds too definite and too great a departure from the conventional view of central bank power, which is 'don't fight the Fed', consider instead the view that the 'crisis' of the last three years is fundamentally a crisis in the modern banking system.

Bernanke, Mario Draghi and Mervyn King are prepared to keep the price of money as low as possible for as long as possible to cushion the banking system as much as they can, despite the potential to turn their central banks from money-creating engines into money-destroying monsters.

Is the consensus choice of a discount rate by many investors therefore something that needs re-thinking? Would this, in turn, imply a re-rating of assets such as stocks and property? Or, alternatively, will investors continue for the foreseeable future to hoard their cash waiting for rates to return to some perceived 'normality'?

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