Forget price/earnings, price/book, price/cash flow ratios. IVR is a much better measure of investment value.

Why a stock is like a bond

LAST MONTH I wrote a column arguing that intrinsic value risk, rather than volatility, is what's important for stocks. IVR is the likelihood that an

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investor's estimate of the present value of a company's future cash flows will be proved wrong. This could happen because of disappointing growth, disappointing profit margins or unexpectedly heavy capital needs.

Since the risk of disappointment obviously increases the further into the future you project, I advised investors to discount more heavily the far-distant cash flows than the more immediate future's cash flows.

Warren Buffett has suggested that the right way to think about a business is to view it as a bond where investors receive a variable stream of coupons. These coupons take the form of dividend payments or share repurchases as the company produces cash flow in excess of the incremental capital it needs to run its business.

That's how a long-term bond is priced: Its value is the discounted present value of all the payments investors expect to receive over the bond's life, including coupons as they mature and the $1,000 return of principal investors will get, say, 30 years from now.

A business is valued in a similar way. As Buffett realizes, its true value is the present value of its expected free cash flow to investors. With a business, however, there is no repayment of principal in 30 years, so an investor must estimate profits far into the future. This takes a good understanding of the business and its prospects.

This view flies in the face of the perceived wisdom that the stock market is obsessed with short-term performance. In fact, the stock market must take a longer-term view than the bond market for the simple reason that a company's equity coupons go on, in principle, forever, while even a long-term government bond's principal will be repaid in 30 years.

As an illustration, I have calculated the intrinsic value of the S&P 400, based upon consensus assumptions about sales growth, profit margins, working capital requirements, current long-term interest rates, and an 11% cost of equity capital. The present value of the resulting free cash flow, or intrinsic value, is $49.66 per share, roughly 7% less than its current price.

More interesting than the intrinsic value, however, is the S&P's time profile. Only 2.7% of the value of the S&P industrials is based on profits earned in 1995, i.e., the market's value would decline by only 2.7% if its 1995 profits were donated to the Boy Scouts. The first 10 years together account for only one-fourth of total value. And you would have to reach 21 years into the future, to the year 2015, to account for half of the market's intrinsic value. Analytically, the stock market is a very long-term bond indeed—akin to the British government's famous Consols, which never mature and therefore sell on pure yield.

This shows why the price/earnings, price/book value and price/cash flow ratios are unreliable measures of valuation. None captures the essential forward-looking nature of investing in the stock market.

Complex though it may sound, this way of looking at stocks is valuable for long-term investors. It is equally valuable to chief executives in developing business strategies to deliver sustainable value to their shareholders.

Managers at one extremely profitable and fast-growing company I worked with last month, for example, were surprised to learn that the duration—or time-weighted average maturity—of cash flows implied by the market's valuation of their company's stock was less than 14 years, compared with 36 years for the S&P. Investors were not giving management credit for being able to sustain its recent performance in the future.

This company's problem is not growth or profitability but sustainable performance. One way to create sustainable value is to become the low-cost producer. Another way is to develop a "branded" product that customers will value more highly than competitive commodity products. Both strategies will lead to higher sustainable operating margins and improved market share.

Investors should ask the same questions about the stocks they own. Does the company have a defendable franchise for creating shareholder value, i.e., the ability to produce sustainable returns for shareholders in excess of those that entrants could earn? Are its managers doing the things today to develop and protect those advantages in the future? These are the minimum questions an investor should be able to answer about a company before buying its stock. ■

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