4.2: Three-Step Valuation Process

While the definition above is more conceptual, we can easily turn it into an applied process to value all stocks, bonds, or other investment opportunities. The process is as follows:

1. Forecast all cash flows which that asset/security is expected to generate over its lifetime.
2. Determine an appropriate discount rate
3. Solve for the present value of the expected cash flows in step one given the discount rate from step two.

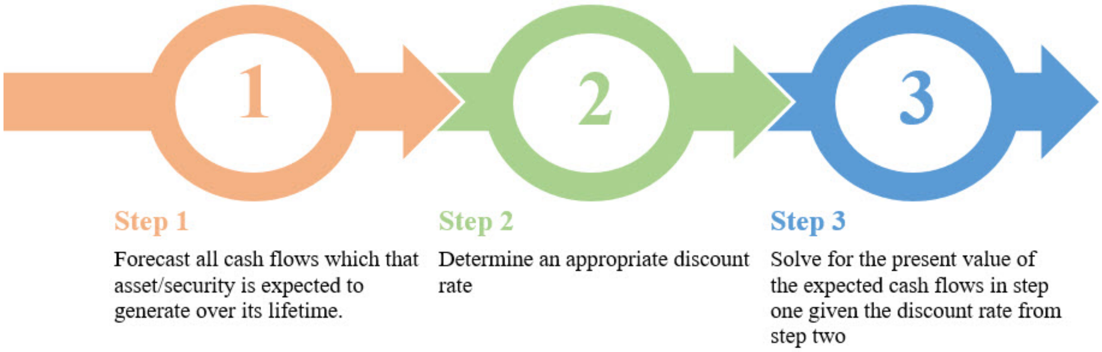

Figure $4.2.1$: Three step valuation process

What changes as we deal with different stocks, bonds, and other investment opportunities is not the process, but how we apply the process. For instance, estimating the cash flows for bonds is simple as the cash flow is generally fixed in size and covers a specific, finite time. On the other hand, estimating the cash flow stream for stocks is trickier because the cash flows are usually variable and potentially infinite. As stocks tend to be riskier than bonds, a higher discount is usually applied. Finally, solving for PV is a straightforward application of the 5-key approach for bonds while it typically involves formulas and/or the cash-flow worksheet for stocks.