4.1: Valuation Concepts

Valuation Definition – The value of any financial asset/security is equal to the present value of all cash flows which that asset/security will generate over its lifetime discounted back to today at an appropriate discount rate.

A financial security refers to an instrument such as a stock or bond that represents a financial claim against assets. The primary difference among different assets/securities (such as stocks vs. bonds vs. corporate projects) is that each asset/security will have a different cash flow stream and a different discount rate depending on the riskiness of that cash flow stream. For example, as was covered in Chapter One, bonds typically have a fixed cash flow stream over a finite time horizon while stocks typically have a variable cash flow stream over a potentially infinite time horizon. Stocks also tend to be riskier than bonds, which results in investors demanding higher rates of return to compensate for the additional risk. While financial securities may have different characteristics, the concept of valuation is essentially the same regardless of the specific security.