

## 14.3: Stock Value

### Learning Objectives

1. Explain the basis of stock value.
2. Identify the factors that affect earnings expectations.
3. Analyze how market capitalization affects stock value.
4. Discuss how market popularity or perception of value affects stock value.
5. Explain how stocks can be characterized by their expected performance relative to the market.

The value of a stock is in its ability to create a return, to create income or a gain in value for the investor. With common stock, the income is in the form of a dividend, which the company is not obligated to pay. The potential gain is determined by estimations of the future value of the stock.

If you knew that the future value would likely be more than the current market price—over your transaction costs, tax consequences, and opportunity cost—then you would buy the stock.

If you thought the future value would be less, you would short the stock (borrow it to sell with the intent of buying it back when its price falls), or you would just look for another investment.

Every investor wants to know what a stock will be worth, which is why so many stock analysts spend so much time estimating future value. Equity analysis is the process of gathering as much information as possible and making the most educated guesses.

Corporations exist to make profit for the owners. The better a corporation is at doing that, the more valuable it is, and the more valuable are its shares. A company also needs to increase earnings, or grow, because the global economy is competitive. A corporation's future value depends on its ability to create and grow earnings.

That ability depends on many factors. Some factors are company-specific, some are specific to the industry or sector, and some are macroeconomic forces. Chapter 12 discussed these factors in terms of the risk that a stock creates for the investor. The risk is that the company will not be able to earn the expected profit.

A company's size is an indicator of its earnings and growth potential. Size may correlate with age. A large company typically is more mature than a smaller one, for example. A larger company may have achieved economies of scale or may have gotten large by eliminating competitors or dominating its market. Size in itself is not an indicator of success, but similarly sized companies tend to have similar earnings growth<sup>[1]</sup>.

Companies are usually referred to by the size of their market capitalization or market cap, that is, the current market value of the debt and equity they use to finance their assets. Common market cap categories are the sizes micro, small, mid (medium), and large, or

- micro cap, with a market capitalization of less than \$300 million;
- small cap, with a market capitalization between \$300 million and \$2 billion;
- mid cap, with a market capitalization between \$2 billion and \$10 billion;
- large cap, with a market capitalization of more than \$10 billion.

The market capitalization of a company—along with industry and economic indicators—is a valuable indicator of earnings potential.

The economist John Maynard Keynes (1883–1946) famously compared the securities markets with a newspaper beauty contest. You "won" not because you could pick the prettiest contestant, but because you could pick the contestant that everyone else would pick as the prettiest contestant. In other words, the stock market is a popularity contest, but the "best" stock was not necessarily the most popular.

Keynes described investing in the stock market as follows:

"The smart player recognizes that personal criteria of beauty are irrelevant in determining the contest winner. A better strategy is to select those faces the other players are likely to fancy. This logic tends to snowball. After all, the other participants are likely to play the game with at least as keen a perception. Thus, the optimal strategy is not to pick those faces the player thinks are prettiest, or those the other players are likely to fancy, but rather to predict what the average opinion is likely to be about what the average opinion will be."<sup>[2]</sup>

In the stock market, the forces of supply and demand determine stock prices. The more demand or popularity there is for a company's stock, the higher its price will go (unless the company issues more shares). A stock is popular, and thus in greater demand, if it is thought to be more valuable—that is, if it has more earnings and growth potential.

Sometimes a company is under- or overpriced relative to the going price for similar companies. If the market recognizes the "error," the stock price should rise or fall as it "corrects" itself.

A **growth stock** is a stock that promises a higher rate of return because the market has underestimated its growth potential. A **value stock** is a stock that has been underpriced for some other reason. For example, investors may be wary of the outlook for its industry. Because it is underpriced, a value stock is expected to provide a higher-than-average return.

Stocks may be characterized by the role that they play in a diversified portfolio—and some by their colorful names—as shown in Table 14.3.1 .

Table 14.3.1 : Definitions of Stocks and their Roles in a Portfolio

	Definition	Role
Growth stock	Underestimated potential for growth.	Expect a higher rate of return.
Value stock	Undervalued by the market; underpriced.	Expect a higher-than-average return.
Defensive stock	Less volatility than the overall market and less sensitive to market changes.	Expect the value to fall less than the market's during a market decline.
Cyclical stock	More volatility than the overall market and more sensitive to market changes.	When the market rises, expect the price to rise at a higher rate. When the market falls, expect the price to fall at a higher rate.
Speculative stock	Overvalued by the market; overpriced.	Expect the price to continue rising for a time before it falls.
Blue chip stock	Stock of a stable, well-established, large cap company.	Expect stable returns.
Widow-and-orphan stock	A blue chip defensive stock.	Expect a steady dividend.
Wallflower stock	Overlooked and therefore underpriced.	Expect the value to rise when the stock is "discovered."
Penny stock	Low-priced stock of a small or micro cap company.	Expect the value to rise if and when the company succeeds.

Each term in Table 14.3.1 names a stock's relationship to the market and to investors. For example, an investor who wants to invest in stocks but wants to minimize economic risk would include defensive stocks such as Boeing (a large military contractor) in the stock portfolio along with some blue chips, such as Coca Cola or Proctor and Gamble. Implicit is its potential for price growth, risk, or role in a diversified portfolio.

#### Summary

- A stock's value is based on the corporation's ability to create and grow profits.
- Earnings expectations are based on economic, industry, and company-specific factors.
- The size of the market capitalization affects stock value.
- A stock's market popularity or perception of value affects its value.
- Stocks can be characterized by their expected behavior relative to the market as
  - growth stocks,
  - value stocks,
  - cyclical stocks,
  - defensive stocks, or
  - other named types (e.g., blue chip stocks, penny stocks).

## ? Exercises

1. Compare and contrast equity investment opportunities in relation to market capitalization. Start by reading *Forbes Magazine's* article on the "Best 100 Mid-Cap Stocks in America" at [http://www.forbes.com/2007/09/25/best-midcap-stocks-07midcaps-cx\\_bz\\_0925midcap\\_land.html](http://www.forbes.com/2007/09/25/best-midcap-stocks-07midcaps-cx_bz_0925midcap_land.html). Click on one or more of the "top 10" and read about those companies. According to *Forbes*, what is the advantage of investing in mid cap stocks? Now go to the Securities and Exchange Commission's (SEC) page on micro cap stocks, also known as penny stocks, at <http://www.sec.gov/investor/pubs/microcapstock.htm>. How are micro cap stocks traded? Why might investors be attracted to micro cap stocks? According to the government, what are four reasons that investors should be wary of micro caps? What is a "pump and dump" scheme?
2. Find and list examples of defensive and cyclical stocks online. Start at [www.bionomicfuel.com/stock-se...e-vs-cyclical/](http://www.bionomicfuel.com/stock-se...e-vs-cyclical/). What is a sector? What are the eleven sectors and which of them are regarded as defensive? As an investor when might you consider defensive stocks over cyclical stocks? Choose a sector that interests you and read about small cap, mid cap, and large cap companies in that sector. What are their stock prices? What do their recent price histories tell you about their perceived value in the stock market? Write your observations in your personal finance journal and share your observations with classmates.

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<sup>[1]</sup> E. F. Fama and K. R. French, "The Cross-section of Expected Stock Returns," *Journal of Finance* 47 (1992): 427–86.

<sup>[2]</sup> Burton G. Malkiel, *A Random Walk Down Wall Street* (New York: W. W. Norton & Company, Inc., 2007).

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