INSIGHTS & THINQING

THE ART & SCIENCE OF EQUITY VALUATION

JUNE 2023

SENTIO
INVEST FOR GOOD

The art & science of equity valuation

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Historically, investment analysts were often criticised for using “overly mathematical” methods to determine the true value of assets and stocks. This approach was jokingly referred to as "physics-envy" and was not always accepted by practitioners in the field of market analysis. In addition, many believed that the market was efficient and that actively managing investments was not worthwhile.

This was understandable during a time when successful managers relied heavily on their intuition and market knowledge. Individuals like George Soros, Peter Lynch, and Stanley Druckenmiller were regarded as the skilled masters of their trade, the Picassos of the market. However, the likes of Benjamin Graham and Warren Buffett demonstrated that basic numerical methods could be just as effective in evaluating stock values. They introduced the notion that investing could also be approached through scientific means.

There is still an ongoing debate between proponents of passive investment and advocates of active management. Those who support passive investment believe that active management is not worthwhile in an efficient market, while fundamental investors argue that valuation still matters in the long run.

Although most active managers fail to exceed their benchmarks, a significant number of fundamental investors consistently add value (Buffett being the most well-known). The track records of these managers show that the skill and expertise of active management should not be overlooked.

According to Frank J. Fabozzi's 2017 CFA paper, asset managers can be described as "disagree-ers" because they make forecasts based on information they believe is not reflected in the market price. In simpler terms, active managers believe that their forecasts of the context and valuation differ from the majority of the market, and Sentio likes this description of active management!

Equity valuation is an essential part of active management that helps investors determine the intrinsic value of a company's shares. It involves combining the quantitative analysis of past and future trends with the contextual "story" that brings the numbers to life. In his book *"Narrative and Numbers: The Value of Stories in Business"*, Aswath Damodaran emphasises the significance of the narrative, especially in cases where there is not enough historical data to support a scientific analysis. He refers to investing as an art form that requires a solid understanding of the numbers and the story behind them.

To evaluate a company's shares, analysts rely on the "Science of Equity Valuation." This approach uses a variety of quantitative techniques and financial models. Fundamental analysis is an essential aspect of equity valuation. It involves carefully reviewing a company's financial statements. This analysis helps analysts assess a company's financial health, performance, and growth potential. Based on this in-depth research, analysts can develop an opinion about the value or range of value of the company's shares.

Valuing stocks can be done in different ways, and it's important to understand how each method works. One popular technique is the Discounted Cash Flow (DCF) analysis, which estimates the current value of a company's future cash flows. Another simple quantitative approach is Relative Valuation, which compares a company's valuation multiples (such as price-to-earnings or price-to-sales ratios) to those of similar companies in the industry. Our philosophy at Sentio is to understand which method best determines the stock's value.

So where does the “Art of Equity Valuation” feature? Equity valuation is not solely dependent on quantitative methods. There is also a subjective aspect, which involves incorporating qualitative factors into the science of the numbers. For instance, determining an accurate discount rate involves assessing the company's risk profile, considering factors such as its industry, financial stability, ESG and country risk. Though financial models provide a starting point for valuation, analysts often need to make further adjustments to account for unique characteristics such as merger synergies or costs.

Valuing equity is a dynamic process that combines scientific methods with subjective judgment from human beings. The quantitative techniques and financial models belong to the science of valuation, while the subjective judgments, qualitative assessments, and necessary adjustments belong to the art. Sentio has taken the science of valuation to the next level by utilising and incorporating extensive data, artificial intelligence, and machine learning tools into its investment process. In a world scarce of Alpha, our hybrid intelligent process combines human investment experience with data science, adding depth to our research and increasing the chances of outperforming the market at lower levels of risk.

MOHAMED MAYET

Mo is the CEO and co-founder of Sentio. He has been a Portfolio Manager at Sentio for 16 years and heads the equity division. During this time, the team has researched and analysed both domestic and global stocks, successfully navigating major crises such as Covid. He co-founded the Sentio investment process, which uses a hybrid approach to AI and machine learning. The Sentio process has grown and further developed into global markets, multi asset and fixed income. His global experience has been a key driver in the growth in the global equity team.

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2007/018379/07

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