

**Fundamental Information and Securities Values:
A Survey of Research and Practice Concerning the Value Drivers of
Equities**

**By
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I. What's In the Numbers

The extent to which corporate fundamentals—earnings, cash flows, revenues, and asset values—drive securities values, and investors' ability to properly price those fundamentals. Specific issues:

1. The association between fundamental information and stock prices.

Extensive evidence indicates that fundamental information—data reported in corporate financial reports—is strongly associated with stock prices, returns, and volatilities. The main value drivers are earnings, cash flows, and book values (net asset values). The longer the period examined (e.g., earnings and stock returns aggregated over 3-5 years) the stronger the price-fundamentals statistical association. Certain fundamental variables (e.g., cash flows) are not only associated contemporaneously with stock returns but also exhibit a certain predictive power with respect to future returns.

Conclusion: Corporate fundamental variables are the major value drivers of corporate equities.

2. **The value-growth enigma.**

The preceding conclusion about the role of fundamentals in valuation may not be surprising; after all, securities prices should reflect the underlying values of business enterprises. Yet, the relationship is far from simple. Extensive economic and finance research discovered a host of anomalies: systematic mispricing of securities relative to their intrinsic value. The most prominent of those mispricings is the value vs. growth difference in stock performance, going back to Graham and his disciple Warren Buffet. The anomaly: “value” stocks (those with low market values relative to fundamentals, such as book value) systematically outperform (yield higher risk-adjusted returns) “growth” (or glamour) stocks (those with high valuation relative to fundamentals). This is clearly inconsistent with efficient (rational) capital markets. The most probable reason: Systematic overpricing of growth stocks and underpricing of value stocks, related to behavioral fixations and misinterpretations of financial information.

Conclusion: Capital market anomalies relative to fundamentals abound, creating profitable investment opportunities.

II. **What’s Behind The Numbers**

Financial statement information is produced by managers, the persons being evaluated by that information. This basic conflict of interest creates strong incentives to manipulate the information. Manipulation is indeed prevalent and is facilitated by the major vulnerability of accounting—its overwhelming reliance on estimated and projections. Specific issues:

1. **Financial information management and manipulation.**

Fundamental information, and earnings in particular, are frequently manipulated by managers, using a host of devices. More surprisingly, investors systematically fail to detect such manipulations, paying dearly for the failure. Sophisticated methodologies have been developed to alert investors to financial information manipulation.

Conclusion: Early warning systems of financial information manipulation create profitable investment opportunities.

2. **Financial analysts and the earnings game.**

The thousands of financial analysts following public companies and releasing earnings forecasts and corporate analyses are presumed to be independent monitors of business enterprises. In fact, they are engaged in a complex game with managers of earnings guidance, surprises, and forecast revisions. Research focuses on the quality of analyst forecasts, systematic biases, and what happens to those unfortunate souls (companies) who miss the forecast.

Conclusion: Interesting investment opportunities emerge from the analysts-companies nexus.

III. **And What's Beyond the Numbers**

Roughly 50-75% of the market values of public companies reflect intangible (intellectual) assets, such as patents, brands, trademarks, and organization capital. The accounting system is hopelessly deficient in capturing the value and impact of these assets, which are the major value creators in modern economies. Specific issues:

1. **Systematic mispricing of intangibles-intensive companies.**

Research indicates that the shares of intangibles-intensive companies are systematically undervalued, likely due to the existence of serious information asymmetries from poor accounting. This, naturally, creates attractive opportunities for profitable investment in underpriced securities.

2. **Value indicators of intangibles.**

Intangibles, such as R&D, are obviously risky and difficult to value (e.g., there is no market in R&D). There are, however, indicators of intangibles' value, such as patent attributes (citations), and royalty income from licensing intellectual property. Such indicators have the potential of improving investment decisions regarding innovative enterprises.

Conclusion: The deficient treatment of intangibles assets in corporate financial reports and the consequent mispricings in capital markets create attractive investment opportunities.