MYTH 3 ABOUT DCF: YOU CANNOT VALUE BUSINESSES WHEN THERE IS LOTS OF UNCERTAINTY

Not looking at it is not making it go away!
Uncertainty: A Fact of Life

- Uncertainty has always been part of human existence, though it has transitioned from the physical uncertainty that characterized the caveman era to the economic uncertainty that is more typical of today, at least in developed markets.

- Each generation, though, seems to think that it lives in the age of the greatest uncertainty.
  - That may be partially a reflection of a broader sense of "specialness" that afflicts each generation.
  - The other is a variation of hindsight bias, where we can look at the past and convince ourselves that what actually happened should have been obvious before it occurred.
So, why do we feel so uncertain?

- Low Interest Rates: As rates have dropped, investors seem to have pushed up risk premiums to compensate.

- Globalization:
  - The first is that there seem to be no localized problems any more, with anyone's problem becoming everyone's problem.
  - The center of global economic power is shifting from the US and Europe to Asia.

- Media/Online Megaphones: The speed with which information is transmitted around the world has allowed market risks to go viral almost instantaneously.
The Unhealthy responses

1. Paralysis and Inaction: I will not act until the uncertainty is resolved.
2. Denial and Delusion: If I have more detail or add more decimals, my numbers get more precise, right?
3. Mental Accounting: I will make up a rule of thumb that has no basis in reality but it makes me feel better.
4. Outsourcing: I will ask someone else or listen to an expert. That way, if something goes wrong...
5. Prayer and Divine Intervention: Please God!!
Coping Tools

- Left to our own devices, we will all fall back on these unhealthy responses.
- The only way to reduce the likelihood is to develop coping mechanisms, i.e., healthier processes for dealing with uncertainty.
- Those coping mechanisms will be different for different investors and will reflect their risk aversion, tools and investment philosophy.
1. Have a narrative

- A good valuation has both a narrative (a story that you are telling about a company) and numbers to back it up.

- When faced with uncertainties about specifics, go back to your narrative for the company and reframe the question around the narrative.
  - If events occurring will change your narrative, you should expect your value to change as well.
  - If they do not, they may loom large but have little impact on value.
### 2a. Break down uncertainty

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<thead>
<tr>
<th>Type of Uncertainty</th>
<th>The Difference</th>
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<tr>
<td><strong>Estimation versus Economic</strong></td>
<td>Economic uncertainty refers to the unexpected changes doled out by fate that no amount of research or information is going to give us insight into. Estimation uncertainty relates to judgments in investing and valuation that can be improved by collecting more information and using it better.</td>
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<td>When much of the uncertainty that you face is estimation uncertainty, you should invest in more information and spend more time on analysis, since will improve your accuracy. When much of it is economic uncertainty, the payoff to collecting and analyzing information is much smaller. It is better to make your best judgments and move on.</td>
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<td><strong>Micro versus Macro</strong></td>
<td>Micro uncertainty is at the company-level and may come from management decisions, legal entanglements and even from immediate competitors. Macro uncertainty can be traced back to larger forces, i.e., the swings in fortune caused by changes in inflation, interest rates and economic cycles.</td>
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<td>If the investors pricing stocks, at the margin, are diversified, the rate of return they demand (the discount rate) should reflect only or primarily macro economic risk exposure, since micro economic risks will be averaged out in the portfolio. You will still adjust expected cash flows for micro economic risks.</td>
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<td><strong>Discrete versus Continuous</strong></td>
<td>Continuous risk is risk that you are exposed to on a continuous basis, though the moment-to-moments will tend to be small. Discrete risk is risk that is uncommon but potentially catastrophic.</td>
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<td>Traditional valuation models, built on expected cash flows and risk-adjusted discount rates, are best suited for continuous risks. Discrete and large risks are best reflected by estimating the probabilities of their occurring and the consequences if they do.</td>
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2b. And decide where you will put it..

Continuous risks show up in cash flows & discount rates

Micro economic and company specific risks show affect expected cash flows.

Only macro economic risks get reflected in the discount rate, since investors are assumed to be able to diversify micro risks.

Expected Cash Flows get discounted at Risk-adjusted Discount Rate to get Value

Adjusted Value

Economic risks show up in unexpected changes in value

Discrete risks (distress, nationalization, regulatory approval etc.) are brought in through probabilities and value consequences.

And probability adjusted to arrive at

Estimation risks can be reduced by collecting more information and using it to better estimate cash flows & discount rates.
3. Keep it simple

- **Less is more**: The more uncertainty there is, the simpler my valuation models become, with fewer inputs and less levers to move.

- **Don’t sweat the small stuff**: Separate the big items that matter from those that do not and keep your focus on those items.
4. Make your best estimates

- **Bad News:** You are going to be wrong and not because your information is bad, your models are screwed up or your valuation skills are rusty. It is because the real world is unpredictable.

- **Good News:** You don’t have to be right to make money. You just have to be less wrong than everyone else.
5. Face up to uncertainty

- One reason that we are so troubled by uncertainty is because we are asked to make point estimates (of revenues, margins, risk etc.), when we face probability distributions with each one.
- Being able to input probability distributions, while it does require some homework, for inputs is freeing.
6. Be willing to be wrong

1. **Don’t expect your just rewards**: You can do everything right and still be wrong.

2. **There is no uncertainty in the past**: It is only in hindsight that the great investments of the past seem to be sure things.

3. **Spreading your bets is not a sign of weakness**: Since being wrong is part of the process, loading up on a few big bets will always expose you to a greater chance of being wrong, all else being equal.
Looking for an edge?

- If investing is a game that you can win at, only if you have an edge, finding that edge has become more and more difficult as the investing world gets flatter.
- As we face new uncertainties, one possible edge to consider is that you may be able to train yourself to become better at dealing with uncertainty than most other investors.
- You can exploit that edge when it is darkest, i.e., when markets are in crisis or in the portions of the market where storm clouds have gathered.