DISCOUNT RATE MYTH 4: IT IS A RECEPTACLE FOR ALL YOUR HOPES & FEARS

The Discount Rate as a receptacle...

- Management/Business Quality: Some analysts use discount rates to bring in the quality of management, pushing down discount rates for what they perceive as well-managed firms and pushing up discount rates for poor management.
- <u>Survival Risk</u>: Venture capitalists pump up discount rates to compensate themselves for failure risk, i.e., that many of the firms that they invest in will not make it.
- <u>Double Counting?</u> While these adjustments may seem intuitive, they are dangerous for many reasons: you can double count both the good and bad, you may be adjusting for risks you should not be and biasing your valuations.

The Good Stuff

- If you think a company is well managed and well run, should it have a lower discount rate?
 - □ The answer is no, because the place to show the effects of great management or strong barriers to entry is in the cash flows (as higher current cash flows, higher excess returns and more valuable growth).
 - Note that you will get a higher value for a well-managed firm. You just won't be double counting that value.
- Even the intuition that better management is less risky is not solid.

Why Good Management≠Low Risk

- Consider two companies with vastly different management in the same business.
 - Company A, with "high quality" managers in place is aggressive in its pursuit of growth while also being discriminating, a rare combination that delivers an expected operating margin of 8%, with high variability, with margins ranging from 5% to 11%.
 - Company B has a management team whose governing style is inertia, delivering sub-par margins of 3% but with much less variability (2.5% - 3.5%).
- In this example, company A will have a higher cost of capital than company B but with its higher cash flows, it will also be worth a great deal more.

The Bad Stuff

Type of Risk	Distinction	Effect on value
Estimation versus Economic	Estimation risk is risk that reflects input errors that you are making as an analyst because you are not using the information that you have about the firm. Economic risk is risk that comes from the firm or the macroeconomic environment that cannot be eliminated by collecting more information or processing it better.	Most risk in valuation is economic risk and since there is little that you can do to make it go away, you (as an investor or analyst) can only demand compensation in the form of a risk premium and move on.
Micro versus Macro	Micro risk is related to the company and its competitive environment and thus reflects your expectations of how its management will perform and competitive developments that may affect the company's standing (in good or bad ways). Macro risk also affects the company but it comes from macroeconomic forces (commodity prices, interest rates, economic growth and inflation).	If you are valuing a company for a diversified investor, it is only macroeconomic risk that is incorporated into your discount rate. If the valuation is to an undiversified investor, some or all of the micro risk also has to find its way into the discount rate.
Continuous versus Discrete	If a company is exposed to a risk continuously, as is the case when a company has foreign operations in a floating rate currency, your cash flows and value will change continuously as well. If the risk is discrete, as is the case when the foreign operations are in a fixed-rate currency subject to infrequent revaluations, your value may be unaffected for long periods before undergoing a large change.	Discount rates are designed to capture continuous risks better than discrete risks, especially when the latter are large and potentially catastrophic.

The Risk in the Discount Rate

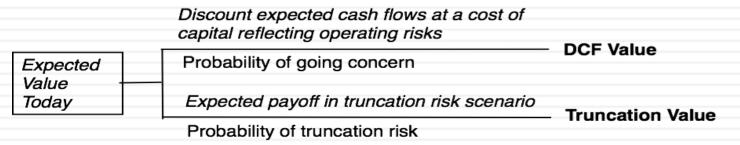
- Going concern risk: A DCF is a going concern concept and the discount rate is designed to capture risks to a going concern.
- Diversified investors? If the investors in this company are diversified, that effectively means that the only risks that should show up in your discount rate are macroeconomic and continuous risks.
- Truncation risk? If you are exposed to large amount of estimation risk, company-specific risk or truncation risk, the discount rate is not a good receptacle for these.

Estimation Risk and Micro (Company-specific) Risks

- With estimation risk, you have to learn to let go. As long as you are just wrong (and not biased), your estimation mistakes will average out over time on your investments.
- With company-specific risks, you should be incorporating the outcomes into your expected cash flow. This is, of course, not a risk adjustment but an expected value. If you are diversified, these risks will average out across your portfolio. If not, you do need to consider how to bring them into your discount rate.

A Better Way of Dealing with Truncation Risk

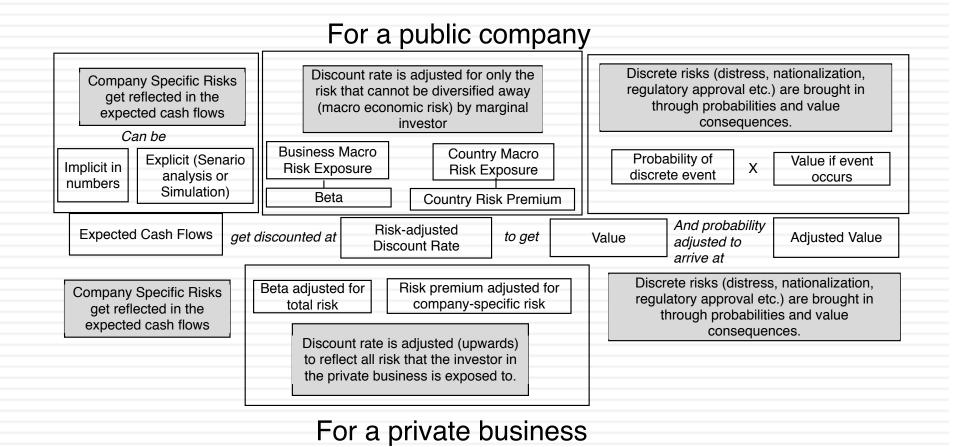
- If your firm is exposed to nationalization risk, regulatory shut down or catastrophic failure, your discount rate is ill-equipped to convey this risk.
- Though these risks do not show up in the discount rates, they will still affect value. To me, the best tool for bringing in the effects of truncation risk is through a decision tree.



The Distractions

- The Margin of Safety: This is the alternative that some value investors offer to discount rates. Since the margin of safety requires a value and a price to use, it is clearly not an alternative, since you need a discount rate to get to value.
- Doing your homework won't make most risk go away:
 No, using more data and doing more research is not going to make risk go away. The only risk that is affected is estimation risk.
- Screening for Risk: Screening for safe assets (cash flows, liquidity, book value) is a pricing tool, not a valuation tool.

A Template for Risk Adjusting Value



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