

Price vs. Value

“Price is what you pay, Value is what you get” –Anonymous

When you buy something you pay a certain price for it. What value you derive depends totally upon you. The value that a child derives from an ice cream or a bar of chocolate is much greater than what (most) adults would derive. Now imagine that this same child has some savvy business sense and wants to sell pieces of the chocolate to his friends. The price of each piece of chocolate may vary depending on the needs and wants of his friends. So in many ways Value is like Beauty, it lies in the eyes of the beholder or more appropriately, the purchaser. If you plan to hoard an item then its price and value is determined by you alone, but if you plan to sell it then its price is determined by what value other people ascribe to it.

Now when other people want to buy this item the price that they will pay, depends on the value they perceive. But it's hard to assess the true worth of an item and most people would rather have someone else figure this out. So the price of an item is the value that a group of people perceive it to possess. Now coming to the case of stocks the price of a share in a company is determined by the value the market ascribes to it. So standard supply and demand logic works but this is accompanied by what the market perceives this share to be worth.

Now we all know that crowds are often wrong and weight of numbers alone doesn't determine right and wrong. So too the market often wrongly prices the value of shares. The price may be right but the value isn't.

Let's see how a stock is priced. The simplest way (easier said than done) is to determine the Value of the company and divide this by the number of shares outstanding. For example-

<i>Scared Bird Airlines</i>	
<i>Value of the Company</i>	<i>Rs 200,000</i>
<i>No. of shares outstanding</i>	<i>1000</i>
<i>Share Price</i>	<i>Rs 200,000/1000</i>
	<i>= Rs 200</i>

But this is far from perfect. We still don't know what the Value of the company should be. It should reflect the future earnings potential of the company, in other words it should factor in the potential for growth. But analysts often can't even predict what the next quarter earnings of companies would be, imagine trying to predict years into the future. Even harder is predicting other factors such as a takeover bid, an accounting scandal or a change in government legislation which all have an impact on the Value of the Company and hence price of the share.

So now I think it's clear that the price of a share is in fact an approximation of the value of a share. The true value is hidden because we lack perfect information. Hence the reason why share prices fluctuate is that the market tries to factor each additional bit of information in the price of a share in order to determine the value of the share.

Sometimes the price is quite close to the value and sometimes it's very far off. The best thing is that no one is truly sure what the value of a share is. That's why markets are so much fun.

So what we have to do is to buy undervalued stocks. The converse is true and we should sell overvalued stocks. Yes difficulties remain in determining value but when we make this jump in thinking not about price but value then success is assured. Now the price of a share is largely irrelevant. It doesn't matter if it's Rs 10 or 100 or 1000, what does matter if it's under or over valued with respect to its price.

In **efficient** markets the price of a stock would be equal to its value. Efficient markets being those where there is perfect information, a large number of buyers and sellers and rational investors. Common sense tells us that markets are not efficient (in spite of what many academics say) and in this, common sense is as usual, correct. Hence the price of a share would rarely if ever be equal to its true value. This fact must be etched in your mind. So never be surprised if a share's price fluctuates wildly, it's just the market reacting to new information.

Even in cases where the market has got the price approximately right there are many fluctuations of price about the true value. An easy way to picture this is to imagine a pendulum. When at rest it is at its true value. However most times it would be oscillating around. This reflects the fact that its price is fluctuating on both sides of the mean value. Over time the oscillations become shorter and the pendulum tends towards rest. Sometimes it might even return to a position of rest but more commonly some new information will enter the market and the pendulum will again fluctuate wildly.

