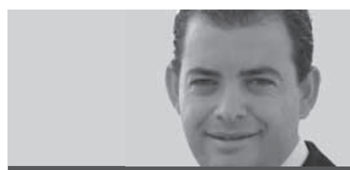
Stock Market Review



Edward Rizzo

Mr Rizzo is director of Rizzo, Farrugia & Co. (Stockbrokers) Ltd.

Price is what you pay, value is what you get

This is a famous quote by Warren Buffet in the 2008 annual report of Berkshire Hathaway Inc. at the peak of the recent financial crises. The CEO of Berkshire Hathaway said that he had learnt this quote from Benjamin Graham, widely recognised as the first proponent of value investing.

The share price of a company and the fair value of a company are very often two distinct features and the quote "Price is what you pay, value is what you get" enables Warren Buffett to explain the meaning behind a value investor.

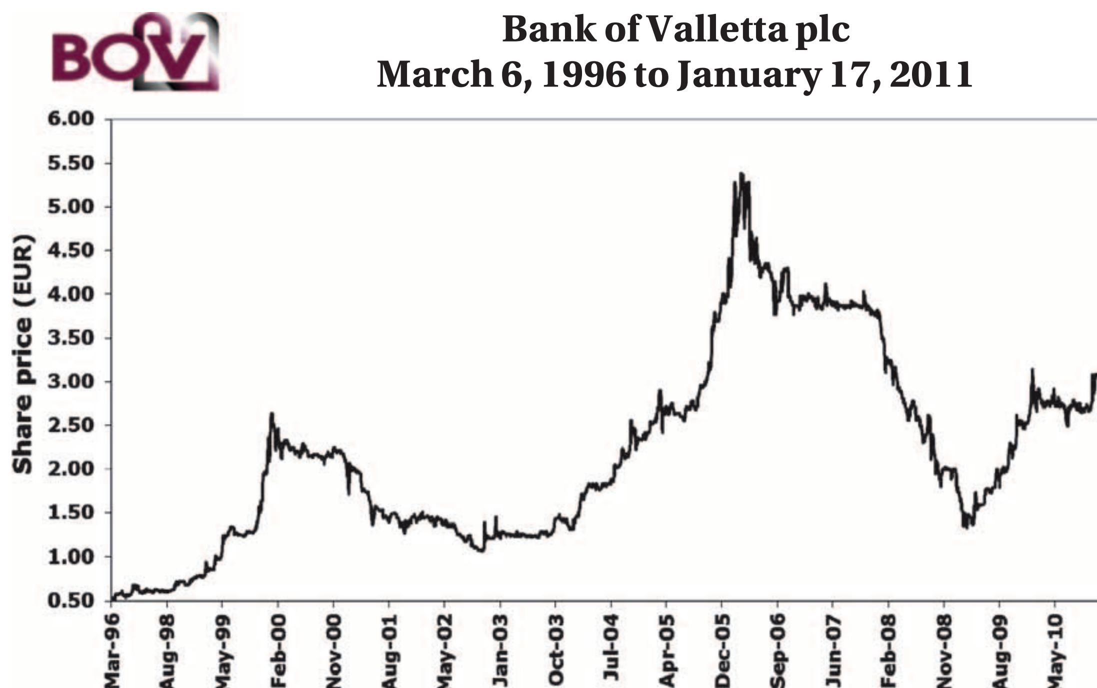
This distinction between price and value is essential for investors. Stock markets rarely price shares correctly, since they very often over-react both on the upside as well as on the downside as investors get carried away by periods of "irrational exuberance" or "bouts of panic".

When you buy a share, you are buying ownership of a business with tangible assets (such as property, equipment and financial assets) as well as intangible assets such as the goodwill of a brand name. The value of these assets does not normally change just because the stock market fluctuates from one day to the next. As long as the fundamentals of the business are strong, the daily share price changes in the stock market do not alter the asset value of the business.

Some international critics define a share price as the value of a company multiplied by investor sentiment. While the value of the company tends to be rather stable, sentiment is very volatile.

Market sentiment is affected by a number of factors hitting the international headlines daily. On the other hand, information of a company's performance is published quarterly or semi-annually. In between, share prices can be very volatile and companies may become under-valued or over-valued, providing opportunities for investors to capitalise on a gain or accumulate further shares for the longer-term.

A parallel can be easily drawn with the property market. If you want to sell your house and someone offers you a low price, you will reject it because it isn't worth the value of your property asset. You would wait until the right offer comes along, hoping to obtain what you regard as the fair price. However, if the neighbourhood starts to deteriorate (for example, a new arterial road is created causing traffic congestion), the value of your house should be lower.



If at this point someone offers a price which is more in line with your adjusted value, you should sell your property. Stock picking should be no different.

Thinking about your portfolio of shares as part-ownership of a business is essential for getting through volatile changes. For this reason, Warren Buffet reinforced his views on value investing during the recent downturn in 2008/9 when he was widely criticised for taking the opportunity and accumulating further shares as the markets collapsed.

Shares should be valued by the quality of the company's fundamentals. In reality, share price movements are normally the result of irrational behaviour and do not reflect the expected future cash flows a business could generate. However, occasional declines in share prices could signal deteriorating fundamentals which need to be recognised.

Although it might be painful to see the price decline in the short-run, as was very evident across all equity markets in 2008 and 2009, if a company's fundamentals are strong and there is evidence that a company can continue to generate strong profitability levels in future years, by time, the share price will catch up with the fundamental value of a company.

How can one relate this to the local context?

Bank of Valletta is a very good example to illustrate the distinction between price and value. In September 2005, BoV had reported a full-year pre-tax profit of €61.9 million and had declared a total dividend that year of €0.121. At the time, the local stock market was going through its second bull market and the share price of BoV had raced to a new all-time high of €5.36 in March 2006.

Five years down the line in 2010, BoV reported a pre-tax profit of €98.9 million (only slightly below its record level) and the dividend during 2010 amounted to €0.191 per share adjusted for the latest bonus issue. Although the bank's profitability and dividend to shareholders were 60 per cent higher in 2010 rather than 2005, the share price is 41 per cent lower. Few could argue that the bank has performed remarkably well over the past five years. However the same cannot be said of its share price.

The 'paper loss' suffered by BoV shareholders who purchased BoV shares at the peak of the market in 2006 is due to the fact that the market was too optimistic on the future prospects of BoV as evidenced by the price to earnings ratio at the time of 31 times and a gross dividend yield of only 2.3 per cent per annum. In other words, many investors ill-timed the market in March 2006 and got carried away by the bullish attitude surrounding local equities.

While the bank has registered a strong growth in profitability and dividends despite the financial crises and the record low interest rate scenario, BoV currently has the lowest price/earnings multiple among the equities on the local market and one of the highest dividends – a very rare occasion and a strong signal for value investors. While in 2005/6, the market was too bullish on BoV, the opposite is probably true today. The P/E ratio today of 12 times, probably does not fully reflect the potential profitability growth once interest rates start to gradually rise in the years ahead.

Another good example is that provided by Malta International Airport plc and MaltaPost plc, two more recent public offerings made by the government. Both share prices have doubled since their first public share offerings in 2002 (MIA) and 2008 (Malta Post) reflecting the strong growth in profitability of both companies during these years.

In 2002, MIA had registered a pre-tax profit of €5.1 million. This climbed to €14.1 million (+176 per cent) in 2009 with dividends to shareholders doubling during this period. Likewise, Malta Post's profitability doubled from €1.6 million in 2007 to €3.2 million in 2010.

With both companies offering attractive dividends to shareholders, it is no surprise that MIA and MaltaPost were the top performing equities of 2010. Despite the sharp increase in their share prices, both companies still offer attractive dividends to shareholders and potential for further profitability growth based on the investments undertaken in recent years and the strategic initiatives being taken by both companies.

A careful analysis of a company's fundamentals is necessary by prospective investors to enable them to select the shares that have the potential to outperform, and on the other hand, to help them stay away from those which are valued excessively by over-bullish sentiment.

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