Mutual funds demystified

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To summarize the discussions thus far:

1. *Positive Wealth Accretion* (PWA) is the main goal of the investment process.
2. *Risk and Inflation* are the main factors determining the outcome.
3. At the time of making the investment, estimates of current risk & inflation are available.
4. *What is relevant is not the 'Past' or the 'Present' but the 'Future'* – Hence an estimate or expectation level of both risk and inflation in the future needs to be made.
5. Different market participants have different methods of arriving at these estimates and take these into account while arriving at the selling/buying price for the securities.
6. *Market forces - laws of 'demand and supply'* determine the actual price at which the buying/selling occurs.
7. Hence, it could be said that the market price correctly reflects the prevailing expectations of risk and inflation.
8. At the end of the investment period, the *actual reality could be very different from the expectation at the time of investment.*

   The winner is the one who, either as an investor or as a seller has been closest to the reality!!
9. How are winners able to do this – *superior information and willingness to act* on the same.

In the next few articles, we will dwell a little deeper into how the different participants' estimate of risk and inflation is reflected in the market price.

To simplify the understanding we will restrict ourselves to stocks.

What does a stock's price in the share market imply?

The stock price is nothing but the total value of the company divided by the number of shares issued by the company.

What is the Value of the company?

The value of the company is nothing but the profits that the company is capable of generating in its entire lifetime (to enable you to understand it - it is similar to a fixed deposit – where the value of the same would be equal to the total interest receivable over its lifetime).

So the value of the company can be obtained in two simple steps

1. Estimate the future profits of the company for every year of its existence and
2. Add up all the profits.

There is a small additional step that we need to perform - For this we will first need to explain the concept of **Time Value of Money**.

Intuitively, this concept means that **A Rupee Tomorrow Is Worth Less Than a Rupee Today!** Hence we cannot simply add up the profits straightaway as profits will occur at different points of time.

But, all of us know this – so what's the big deal? The big deal is –

- Do we know why it is so? and
- By how much is it less? Is it worth 90 paise or 75 paise or 50 paise? and
- How much less is it worth in the second year and how much in the third year and beyond?

To answer the first question – it is worth less tomorrow because of many factors but the main one is inflation, the effects of which we have already discussed and will continue to do so in the future.

The answer to the second question is that the value of the rupee tomorrow will be lower, at least by the level of inflation occurring or expected to occur in that year.

To answer the third question – for simplicity's sake, it is generally assumed that the inflation rate used is an average of inflation rates expected to occur over many years and hence one single rate is generally used for each successive year.

Hence for each year in the future, you will have to bring down the value of the rupee appropriately. This process is called **discounting**. How does this work?

Let us assume that the inflation rate is 10%.

The value of one rupee in the following year should be 10% less ie Re1.00 minus 10 paise equals to 90 paise.

How about the following year? It should be a further 10% less than 90 paise ie 90 p minus 9 p equals to 81 p. And so on for each successive year.

This process of thus reducing the profits by the inflation rate every year is known as discounting.

One thing to bear in mind is that we have oversimplified things for the purpose of explanation (for example, the rate used for discounting is not just the inflation rate, but a much more composite one called the **cost of capital** – but more of that, later) and hence the rate used is referred to as the **discount rate**!!!.

Hence to summarize –

The share price of a company is nothing but the value of the company divided by the number of shares outstanding.

The value of a company is the sum total of all the profits that the company is expected to earn in the future with the proviso that each future year's profit is discounted using cost of capital (one of the components of which is the expected rate of inflation).

More in my next!!