

# Mutual funds demystified

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In the last edition we began dwelling upon Market Dynamics. Let us continue the discussion.

At the outset let's understand so-called fundamentals on which the markets are supposed to be based. When one speaks of about fundamentals, one is generally referring to the rationale on which the computation of the market price of any financial asset rests.

**These fundamentals comprise:**

1. Estimates of future cash flows. The starting point is estimate of future profits of the company – since profit also contains some non-cash items such as depreciation of the assets of the company – it is normal to use cash profits.
2. Estimates of future Weighted Average Cost of Capital (WACC) for the company – while we will do a detailed discussion of this in a future essay, for the present you need to know only the components which are used for its calculation :
  - a) The capital structure of the company - how much equity and how much debt.
  - b) The cost of capital for the equity portion – various models are available to compute this.

- For the purpose of current understanding it is enough to know that the factors involved are
- i) The riskiness of the company's business
  - ii) The expected inflation rate in future and
  - iii) The real risk-free rate (usually borrowing cost of the Government for 91 days).
- c) The cost of capital for the debt portion – the company's borrowing cost adjusted for tax benefit (interest is allowed as an expense and helps reduce tax outgo; so the interest rate paid by the company may not automatically translate into the cost of debt at all times).
- d) Once the above three are known, we calculate the WACC by weighting the equity and the debt cost of capital in their proportion of the capital structure.
3. Next, the WACC (which is nothing but an interest rate and hence expressed in annual percentage terms) is used as the discounting rate to arrive at the Net Present Value (NPV) of the future cash flows of the company.
  4. The NPV is then divided by the number of shares issued by the company to arrive at the NPV per share; this is nothing but the calculated price per share.

An investor venturing into the market place would be armed with this information and if the prevailing traded price of the company's share (referred to as market price) is less than his own computation of the share price then he tries to buy the share.

Now, for every buyer there has to be a seller: Who will sell? He will be another investor who already holds this company's share and has a much lower calculation of the company's share price! How can this be possible? If the computation is supposed to be so scientific, how come two people can come up with widely different estimates of the share price?

The answer lies in the fact that all the above estimates are actually guesstimates of the future – whether it be the future expected inflation, or the future real interest rates or the projections made by the companies (or by analysts) of future sales, costs and profits.

Different companies and different analysts have their own mathematical models, which attempt to factor in the various expectations of the future and the degree of uncertainty they carry, and come up with a narrow range of forecasts with which they project share prices. However, since company -specific information is not freely available; there is enough scope for the forecast from any two analysts to be widely different.

Investors rely on these recommendations to decide on which share to buy or to sell. This is the reason there is an actively traded market in stocks. We must note two aspects:

Most analysts also put in a) enough disclaimers and b) 'subject to x happening' type of language and such type of 'x happenings' do take place. Hence the investors have to take a calculated call on how to modify the price outlook based on these contingent outcomes (depending on happening or otherwise) and whether to go beyond the range that the analyst has given. This explains why there is active trading.

What accounts for the rapid intra-day swings in the market and in individual share prices? While this by itself is a topic for detailed discussion later, we will dwell on one important factor. However sophisticated the mathematical models that are used, it is next to impossible to factor in all of the glorious uncertainties that life can throw up – such as the 09/11 attacks, the tsunami, the China earthquake. Such events, also known as Black Swan events, have the effect of throwing all computations out of gear.

Besides, the growing inter-dependence of global markets means that throughout the trading day there are events happening in other parts of the world which could/would have some impact on companies' future profitability of one or more companies in our country. Human behaviour being what it is there is rapid knee-jerk reactions to such external events. This leads to wild gyrations in the market collectively as well as in prices of individual companies' shares.

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