CENTRE FOR FINANCIAL MANAGEMENT

CFM QUARTERLY IN FINANCE

JULY 2017

EDITOR: DR. PRASANNA CHANDRA

CONTENTS

PART A: ARTICLES/ CASES

1. **HOW TO THINK ABOUT MONEY**
2. **SUPPLMENTARY EVA AND MVA METRICS**

PART B: SNIPPETS

1. **WHAT MAKES A HEALTHY COMPANY**
2. **HOW NORDIC BOARDS CREATE EXCEPTIONAL VALUE**
3. **SATISFACTORY PERFORMANCE VS SUPERIOR PERFORMANCE**
4. **CYCLICALLY ADJUSTED PRICE- EARNINGS (CAPE) RATIO**

PART C: WIT AND WISDOM

1. **HUMOUR**
2. **WISE SAWS**

ARTICLES /CASES

1.HOW TO THINK ABOUT MONEY

Prasanna Chandra

In his book *How to Think About Money*, Jonathan Clemens, an eminent financial writer, provides a guide for a successful financial life. Praising the book John C. Bogle wrote: “Its beauty lies in the commonsense and wisdom that is summed up in just five simple steps that will help you to earn your financial independence. Easy to understand. Easy to follow.”

The five steps which provide the blueprint for a successful financial life are as follows:

Step 1: Buy More Happiness The relationship between money and happiness is far more complex that most people imagine. Academic research has provided the following insights.

- Beyond a point, money does not provide much happiness
- Experiences provide more happiness than possessions. We eagerly anticipate experiences and carry fond memories of the same but quickly adapt ourselves to material improvements.
- Spending money on others produces more happiness than spending on ourselves.
- Often, the fewer the choices, the happier we are.
- Pursuing our goals brings greater pleasure but achieving them is often a letdown.
- Children are a mixed blessing at least when it comes to happiness.
- Satisfaction through life appears to be U- shaped.
- We often adapt quickly to good as well as bad developments in our life.
- Happiness often depends on our relative standing.
- Nearly 50 percent of our happiness is genetically determined, 10 percent is determined by our life's circumstances (age, income, marital status), and 40 percent is determined by how we choose to lead our life (the goals that we pursue, the manner in which we spend our money, the voluntary activities that we do, and the time we spend with family and friends).

Self-Determination Theory and Smart Handling of

Psycholgists Edward Deci and Richard Ryan proposed the so- called self- determination theory w
needs: the need for autonomy, Competence, and relatedness.
If we handle our finances smartly, we can use money to boost our happiness in three ways. First
a greater sense of freedom (autonomy). Second, money allows us to spend our time in doing what
Third, money makes it possible to have special time with those we care about (relatedness).

Step 2: Bet on a Long Life Life expectancy has gone up, thanks to improvements in health care. In the U.S. during the 20th century, the male life expectancy climbed from 52 years to 80 years and the female life expectancy increased from 58 years to 84 years. This is likely to go up, albeit much more slowly. In India, too, currently the life expectancy of an urban citizen is 75 years and it is likely to go up further.

There are four key financial implications of today's impressive life expectancy. First, we need to get ourselves on the right financial track as early as possible so that we can achieve a decent degree of financial freedom as quickly as we can. Second, we should use that freedom to focus on what we are passionate about. Third, we should invest with a long- term horizon and that means a greater commitment to stocks. Fourth, when managing money, we should be less concerned about dying young and more about living a long life.

Step 3: **Rewire Your Brain** About 99.9 percent of human life was spent in the hunter- gatherer phase. The selection processes of that phase have sculpted and shaped our genome and plasticity. So our brains are well designed for the African savannah environment that we faced 150000 years ago but ill- suited for the information age we currently live in. Indeed, there is a profound mismatch between our genes, bodies, and brains and the demands of the modern day environment.

What qualities did our ancestors possess? We do not know for sure, but Jonathan Clemens makes an educated guess as follows: "They likely consumed whenever they could… They imitated others.. They were constantly looking for patterns.. They reacted swiftly to any whiff of danger… They were fiercely protective of their families.. They worked hard."

Behavioural finance experts have identified a number of errors we make in our financial life because of the way we are wired. Clemens has summarised them in the following words. "1. We're too focused on the short- term. 2. We lack self- control. 3. We believe the secret to investment success is hard work. 4. We think the future is predictable. 5. We see patterns where none exist. 6. We hate losing. 7. We sell winners and hang on to losers. 8. We're overconfident. 9. We take credit for our winners, while blaming our losers on others. 10. Our risk tolerance isn't stable. 11. We get anchored to a particular price. 12 We rationalize bad decisions. 13. We favour familiar investments. 14. We put a higher value on investments we already own. 15. We prefer sins of omission to sins of commission. 16. We find stories more convincing than statistics. 17. We base decisions on information that's easily recalled. 18. We latch on to information that confirms what we already believe. 19. We believe there's a safety in numbers. 20. Our financial decisions aren't purely financial- besides being utilitarian, they have expressive, and emotional dimensions. 21. We engage in mental accounting. 22. We're influenced by how issues are framed."

Of the above mental errors, three are especially problematic: lack of self- control, over- confidence, and over- reaction to market decline, partly on account of aversion to loss.

To tackle these mistakes, we need to overcome our instincts and strive to acquire three habits:

- **Save More** We should save more (by keeping our total expenses below 50 percent of pre- tax income) and make saving as painless as possible by signing up to various savings plans. Once these habits become ingrained, our wealth will start to balloon and our sense of financial control will grow.

  In addition, we will enjoy the following benefits: (a) We will need a far smaller nest egg for comfortable retirement. (b) We will have the pleasure of a enjoying a gradually rising standard of living.
- **Embrace Humility** Investment magazines, money managers, stock brokers, business channels, and many others create the impression that by following their recommendations and suggested strategies it is possible to beat the market. The investment industry has a vested interest in keeping that fantasy alive.

  In reality, however, beating the market by active management (with all the costs associated with it) is extremely difficulty. So, investors are well advised to embrace humility and invest in low- cost index funds or exchange- traded funds.
- **Focus on Market's Long- term Performance** While the stock market appears very complex and mysterious, its returns are determined by an interaction of just two factors: investment returns and speculative returns. Investment returns are represented by the sum of dividend yield and earnings growth and speculative returns are represented by the change in the price- earnings ratio. Focus on investment returns which represents the market's long- term performance.

Step 4: Think (Really, Really) Big We are regularly approached by various players in the world of investments and financial services: brokerage firms implore us to trade, mutual funds cajole us to invest in various schemes, banks prod us to make deposits, insurance companies tout the virtues of various insurance policies, real estate agents beseech us to buy properties, automobile dealers offer various baits, and so on.

As these players compete for our business, our financial life is broken down into various parts. We welcome this approach that divvies our finances into neat categories as it appeals to our mental accounting. As Clemens put it: "Bank statements are in one folder. Insurance is in another. We also have folders for the house, brokerage accounts, credit cards, college accounts and more." The problem with this approach is that we do not realise how all these pieces fit together and this may lead to irrational decisions. For example, people have money parked in their savings account earning meagre interest, while carrying credit- card balances

costing much more ; people buy lottery tickets (where the odds are such that they will almost certainly lose if they play long) but shun stocks for fear of losing money (even though a diversified portfolio of stocks should deliver attractive returns over a long period of time) ; people will scramble to a shopping mall when there is a discount sale, but run away from the market when it collapses.

To avoid such irrationalities, you should handle your financial life in a wholistic, integrated manner rather than in a piecemeal, fragmented fashion.

Step 5: To Win, Don't Lose Achieving financial success means having enough money to lead the life one wants. It is not having more wealth than your brother- in law, or beating Nifty index, or having the flashiest car in the neighbourhood- these are just bragging rights that can slip away very quickly.

Everyone has to decide the kind of life he wants. Some of the common themes in people's wish lists are: comfortable standard of living, time for family and friends, time for activities that they are passionate about, and enjoyable vacations. And we want to achieve these goals without worrying about money.

If achieving this kind of financial freedom is our overriding goal, we should pursue strategies that maximize the likelihood of success. And once we have accumulated enough money to lead the kind of life we want, we should be careful to remain winners and avoid taking gambles that could put our victory to risk.

While the blueprint described above is fairly straightforward, implementing it into practice requires thought and effort. As Clemens put it: "We need to ignore our instincts, rein in our emotions, take a deep breath and focus relentlessly on what's best for us- for our happiness and our financial freedom over a lifetime that might span nine decades." Remember Charlie Munger's formula : "Live on less than what you earn, invest wisely, and live a long time."

3.SUPPLEMENTARY EVA AND MVA METRICS

Dr. Prasanna Chandra

In his book *Best Practice EVA: The Definitive Guide to Measuring and Maximizing Shareholder Value* (John Wiley & Sons, 2013), G. Bennett Stewart III, a co- founder of Stern Stewart & Company, who later started E VA Dimensions LLC, recognized that the traditional EVA (as well as MVA) limitations. As an absolute measure, EVA cannot be used for comparing performance over time, across different business segments, or against peers with different scales of operation. Further financial managers found it difficult to implement the traditional EVA methodology. To tackle these limitations, Stewart's firm developed three new EVA metrics to supplement the traditional EVA and MVA metrics

1. $$\text{EVA margin} = \frac{\text{Change in EVA}}{\text{Last year's sales}}$$

According to EVA Dimensions LLC: "EVA Margin neutralizes comparisons between capital lean firms like Wal- Mart that run with miniscule operating margins, and margin rich businesses like Intel that ties up mammoth amounts of high risk production capital." EVA Margin fully and correctly recognizes superior asset management and the success in achieving lean, high velocity business models.

2. $$\text{EVA momentum} = \frac{\text{(This year's EVA – Last year's EVA)}}{\text{Last year's sales}}$$

EVA momentum is a metric which is based on the percentage change in profit rather than the level, so companies of various sizes can be compared. Further, since the level of assets is incorporated in the level of sales, it provides an objective measure for comparing vastly different businesses. Firms should seek to maximize the EVA momentum, Stewart says, "EVA momentum is the only corporate ratio indicator where bigger is always better, because it gets bigger when EVA gets bigger, which means that a firm's NPV, MVA, and shareholder return are getting bigger, too."

3. Market – Implied EVA Momentum (MIM) MIM is calculated by solving for the EVA growth trajectory that results in the observed MVA (Market Value Added). Put differently, it is the EVA growth rate baked into a company's share price. MIM truly reflects the consensus of investor expectations. It is superior to the familiar "consensus" earnings share.

Large MIM rates indicate that investors believe a company is poised to achieve significant performance improvement; low or negative MIM rates suggest that the company will face intense competitive headwinds.

According to EVA Dimensions LLC: "Monitoring MIM is a good way to free- ride on the forecast judgments of the investment community. CFOs are using MIM to help them set plan and performance targets, even compensation benchmarks, and investors are using it to get a reliable read on market expectations to compare against their own."

B.SNIPPETS

1. What Makes a Healthy Company

What makes a healthy company? According to Ian Davis, Worldwide Managing Director of Mckinsey, the following are the generic components of a healthy company.

- A robust and credible strategy.
- Productive, well maintained assets
- Innovative products, services, and processes

- A fine reputation with customers, regulators, government, and other stakeholders.
- The ability to attract, retain, and develop high- performing talent.

2. How Nordic Boards Create Exceptional Value

Since 1999, Boston Consulting Group (BCG) has published annual rankings of top value creators based on total shareholder return (TSR) over the previous five years.

In the BCG's annual study of value creation, Nordic companies have consistently outperformed the global average, whether we look at annualised returns over time periods of 5,10, or 15 years.

An important contributor to Nordic companies' superior returns, according to BCG, is their unique model of corporate governance. In their article, "How Nordic Boards Create Exceptional Value," Lars Faeste et.al of BCG observed, "The Nordic model establishes a board of directors that does not include any of the company's executives. This non-executive board's responsibilities include appointing and monitoring the CEO, approving the corporate strategy, and overseeing legal compliance and risk management."

3. **Satisfactory Performance vs Superior Performance**

Benjamin Graham once said, "To achieve satisfactory investment results is easier than most people realize; to achieve superior results is harder than it looks."

Why is it harder to achieve superior results? According to William Bernstein, investors must have four basic abilities to be achieve superior results, an interest in the investing process, math skills, a firm grasp of financial history, and the emotional discipline to adhere to a plan. Bernstein believes that most investors do not have the full skill set to succeed. He says, "I expect no more than 10 percent of the population passes muster on each of the above counts. This suggests that as few as one person in ten thousand (10 percent to the 4th power) has the full skill set."

Given these stiff requirements for achieving superior investment performance, the average investor, when he strives to achieve superior results will, more often than not, achieve below average performance.

4. Cyclically Adjusted Price- Earnings (Cape) Ratio

Developed by Robert Shiller, the CAPE ratio is defined as follows:

Current S & P 500

CAPE ratio = ______________________________

Average S & P earnings over 10 – years adjusted for inflation

The average CAPE ratio for 20th century was 15.2. According to Shiller, if the CAPE ratio is significantly higher than 15.2, it suggests that the market is over- priced. Likewise, if it is significantly lower than 15.2, it suggests that the market is under-priced.

PART C: WIT AND WIDSOM

1. HUMOUR

- When Queen Elizabeth, on a visit to New Delhi, expressed a desire to see Taj Mahal.
  Nehru said, "I will also came."
  Subramaniam added, "I too."
  Kamaraj joined, "I three."
- Three accountants and three engineers were travelling by train to attend a convention,. The three accountants bought a ticket each, but the three engineers bought just one ticket.
  An accountant asked the engineers "How will you manage with one ticket." "Wait and see," replied the engineers.
  After boarding the train, the three engineers crammed into a restroom and closed the door behind them. When the conductor came to collect the tickets, he knocked at the restroom door and said, "Ticket please." The door opened just a bit and a single arm emerged with a ticket in hand. The conductor collected it and moved on.
  On their return journey, the accountants decided to imitate the engineers and bought just one ticket. The engineers, however, did not buy even a single tickets. Puzzled, the accountants wondered what the engineers were up to. After boarding the train, the three accountants crammed themselves into a restroom and closed the door behind them. The three engineers too did the same in a nearby restroom. After a while, one engineer came out, knocked at the door of the restroom occupied by the accountants and said "Ticket please."

2. WISE SAWS

- "I am a great believer in luck, and I find that the harder I work the more I have of it."

  Thomas Jefferson
- In the business world, the rearview mirror is always clearer than the windshield."

  Warren Buffett