Risk and Return are Inseparable

Before you engage an appraiser or read a report you should reflect on - Revenue Ruling 59-60, Section 3. This simple statement is the basis for all sound valuations.

"The value of shares of stock of a company with uncertain prospects is highly speculative. The appraiser must exercise his [or her] judgment on the degree of risk related to all of the factors affecting value. Valuation of securities is a prophecy as to the future."

Where the possibility of profit is high, the risk of failure is may also be high. *(Stated simply, there is no free lunch.)* Appraisers are and should be masterful “risk assessors".

Every generation relearns this important lesson!

<u>Remember the investment crazes of the last 50 years</u>:

First we had...Conglomerate companies in the 1960s,

Then... crude oil in the mid 1970s,

Then... collectibles and hard assets in the late 1970's

Then... leveraged buyouts in the 1980s, and

Then... dotcoms, tech stocks and stock options in the 1990s

Then...real state and derivatives in the 2000s

And...Banks, insurance companies and "currencies" more recently

Each craze lasted a few years. In the beginning *(a biblical reference)*, innovative investors spotted opportunities. The speculative herd poured in money, driving up prices. The bubble burst. However, business appraisers should and must look beyond these temporary phenomena. They must be ignored them if they are not "fundamentals" or "value drivers".

Many stock options were valued for private companies during the last craze. Options have two value components: current and future. Current value is easy: if the stock today sells for more than the exercise price, current value is just exactly the difference. *(Exercise the option, pay the price, and sell the stock: the profit is the option value.)* Future value is based on the Black-Scholes formula, which quantifies the probability of …and…amount that the stock price will exceed the exercise price when the option expires. A major assumption is volatility: how much will the stock price go up and down?

Volatility is easily measurable for public stocks with trading price histories. For private companies, however, there are no price histories. Many analysts assumed that private companies had volatilities comparable to those of public companies. Their fundamental error was the HUGE implicit assumption that the private companies would or could go public. <u>That was beyond speculation and into the realm of the fantastic</u>, as shown by the popping of the market bubble.

The Appraiser should have taken the conservative position that, since these stocks were not public, there was no volatility and therefore they have no future option value. They should have been valued solely at present value. Harking back to the opening quotation, good judgment would say: the key "factor affecting value" was that the companies were private and one could not "prophesy" their going public.

Valuation is indeed a prophecy of the future.

Nevertheless, it must be based on considered judgment, <u>not</u> unsupported assertions.

Risk and Reward are Inseparable!