

The Economics of Business Valuation Discounts and the Competitive Risk-Return Paradigm

This is an academic text in Business Valuation, which is a sub-field of Economics.

Excerpts...

"Business appraisers who seek substantive answers to common valuation questions, questions that may not have been adequately answered in the current business valuation literature, may find this text engaging, informative and thought-provoking" (p. v).

"For practitioners who would like to provide substantive, compelling, and convincing support for their deviations from generally accepted business valuation practice, in order to meet a Daubert Challenge for example, this text may provide a useful resource" (p. iv).

"For academic economists, especially those looking for instructive real world examples of Applied Microeconomics, this text may provide several examples of how economic theory is applied in business valuation practice" (p. v).

"Financial economists may find the author's analysis and conclusions regarding a competitive asset market risk-return relationship, which is discussed in the context of the Traditional CAPM, to be controversial, yet thought-provoking" (p. vi).

"Economics underlies much of business valuation theory and practice, yet there appears to be surprisingly little explanation of how it fits into and underlies the typical business valuation analysis. Indeed, analyses of market value are inextricably linked to an underlying foundation of Economics, since market value (and price) is a function of the interaction of market supply and demand" (p. v). "...the typical absence of an explicit Fair Market supply and demand analysis of the DLOM, one which is consistent with accepted economic theory...raises a red flag. The present author does not see how one can sufficiently support a claim that one's DLOM analysis produces a Hypothetical Fair Market discount when an explicit (or even a readily-apparent implicit) analysis of the Hypothetical Fair Market (i.e., Hypothetical Market supply and demand curves) is not performed" (p. 285).

"From a larger perspective, this text attempts to link and integrate business valuation theory and practice with its economic underpinnings in formal and explicit ways" (p. v).

"although the typical investor in closely-held company interests, in the actual market for closely-held company interests, may be undiversified, the Hypothetical Investor in a subject closely-held company interest—in the Hypothetical Market, and with investor characteristics required by the FMVS that are superimposed upon him—is a well-diversified investor" (p. 58). "An appraiser must assume that the Hypothetical Investor is rational and well-informed, which, by direct and unambiguous implication, means that the Hypothetical Investor knows the benefits of diversification and has already positioned himself as an owner of a well-diversified portfolio of

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assets. As a well-diversified investor, a closely-held company interest's non-systematic risk (if any) is diversified away when it is included in the Hypothetical Investor's well-diversified asset portfolio. ...Under the FMVS, the inclusion of any form of non-systematic risk adjustment or discount in the valuation of minority interests in closely-held companies, including FLPs, is an unmistakable error" (p. 62).

"The MAPM Analysis is the present author's recommended way of estimating an objective, market-determined DLOM for minority FLP interests" (p. 281). "The adjustment to the benchmark DLOMGC,CEF is quantified objectively by the market, not subjectively by an appraiser" (p. 273).

"Appraisers have embraced the Traditional Capital Asset Pricing Model, or CAPM, as a theoretical foundation for the discount for lack of a market (DLOM)" (p. 331). "The present author interprets the price function in Equation 14.4—not as the market equilibrium price—but as the CAPM's

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demand-side relationship between the relevant exogenous shift factors (including systematic risk) and the position of the demand curve when investors are risk-averse" (p. 345).

"Sharpe (2007) agrees that a more complete understanding of the risk-return relationship can be obtained by including a broad spectrum of investors who possess diverse, and varying degrees of, preferences for risk" (p. 381). "In a competitive asset market that includes a broad spectrum of investors with varying degrees of risk tolerance, there can be a negative or inverse relationship between an asset's systematic risk and its equilibrium market rate of return" (p. 384).

"For taking on higher risk, which is a higher variance of expected rate of return, the investor

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hopes to get a higher rate of return. There is a prospect or possibility to earn a higher rate of return on an asset that has a greater variance in its rate of return (i.e., higher risk), but that does not mean it is a sure thing. Just because you want a higher rate of return, does not mean the market will provide it to you. One's realized rate of return might be on the downside of an asset's rate of return variance" (p. 174). "Consistent with the present author's view, Markowitz (2008)...concludes that it is inaccurate to interpret the Traditional CAPM's positive, linear relation between expected beta risk and expected return as indicating or meaning that 'CAPM investors are paid for bearing systematic risk' (p. 91)" (p. 362).

"...risk-loving investors are willing to take on the extra risk in return for the opportunity to earn a higher rate of return that was created by a higher up-side variance in Asset 1's normal probability distribution. That does not mean that risk-loving investors "require", or even expect, that they will earn a higher up-side rate of return. There is no certainty that anyone will earn a higher rate of return on assets with higher systematic risk..." (p. 388). "Notice that there is no universal rule or expectation of receiving a higher rate of return on an investment in the more risky asset. The opportunity, which is not a certainty, to earn a possible higher rate of return is reserved for only those investors who are quick enough to purchase Asset 1 before Asset 1's price has a chance to adjust fully upward to its new equilibrium level that is commensurate with its now-higher systematic risk" (p. 390).

"if a positive risk-return relationship is not representative of the adjustment process toward a new competitive asset market equilibrium, a Fair Market DLOM may be unfounded. The present author has shown that, when one assumes that a competitive asset market includes heterogeneous investors (risk-loving as well as risk-averse investors), where risk-loving investors' aggregate response can dominate that of risk-averse investors, ...a competitive asset market may exhibit a negative risk-return relationship" (pp. 396-397).

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