October 2020

Fair Value vs. Target Price

What's the Difference?

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The cornerstone of any successful equity investment approach is the basic strategy of buying a stock at a price that is lower than that which it can be sold for. This philosophy is captured through the age-old saying "buy low-sell high". The challenge for investors though is determining what constitutes "low" and "high"? Just because a stock declined in price doesn't mean that it is an attractive investment worthy of consideration for purchase. There could be many valid reasons that support the price decline including business deterioration, management changes, economic variables, etc. Likewise, a stock increasing in value shouldn't automatically be sold. There may be viable rationale for the price increase that could lead to additional gains well into the future. So how does an investor determine when to buy or sell a stock?

Most any investment boils down to an initial outlay followed (hopefully) by a stream of future income (earnings). The challenge is deciding a fair price to pay for the expected stream of future income. Two common methods used to determine the attractiveness or unattractiveness of a prevailing stock price at a given point in time are Fair Value and Target Price. Fair Value attempts to calculate what a particular stock is worth while Target Price estimates how much other investors are willing to pay for the stock.

Because of its longer-term approach and emphasis on cash flow (vs. reported earnings), IRA Group utilizes a Fair Value methodology in determining the relative price attractiveness for individual stocks and the overall equity market on a daily basis.

The Key Differences

The Fair Value approach emphasizes cash flows, while Target Price focuses on earnings estimates. Both are measures of profitability, and both depend, to a large degree, on the analyst's projections of future performance. However, a company's management often has more discretion over how to report earnings, which can lead to distortions or accounting sleight of hand. Cash flows, on the other hand, are less vulnerable to manipulation.

The time frame also matters. For instance, when thinking about a company's prospects and how much profit it can generate - analysts using a Fair Value methodology tend to look at 10, 15, or 20 years into the future. As a result, they will not be overly concerned with earnings in the next few quarters. On the other hand, analysts establishing Target Prices are generally projecting out over a 6- to 12-month time period. Because of this shorter window, these models focus on the company's ability to meet short-term forecasts for the next quarter and year.

IRA Group believes that, as long as an investor has an idea of what a stock is worth, he or she is in a better position to determine whether it is at buy below price or sell above price. This view supports our Fair Value approach.

Keep in mind that what something is worth is not always the same as what someone is willing to pay for it. Consider the last time you bought a pair of shoes on sale and felt like you found a bargain because you paid less than you felt the shoes were worth. Or, conversely, the last time you went out for a meal and felt it wasn't worth what you paid. Fair values are meant to provide an estimate of what the stock is worth, irrespective of what investors are willing to pay for it.

Fair value estimates are more of a guide than automatic buy or sell prices. As long as the investor has a good idea of what a stock is worth, they will be in a better position to determine whether it is undervalued or overvalued.

Fair Value

Long-Term

Cash Flow

Target Price

Short-Term

Earnings Estimates

Observation

Benjamin Graham, the famed value investor, said that in the short run, the stock market is like a voting machine tallying up which companies are popular and unpopular. But in the long run, the market is like a weighing machine assessing the substance of the company. Target Prices are meant to appeal to the voters while Fair Values are meant to be unemotional assessments of value.