# Stock Valuation spreadsheet blog

by Daniel Sparks

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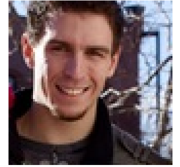


## Are Stocks Risky?

These days when someone mentions “stocks” it results in negative connotations. The myth is that stocks are risky and this train of thought is valid to a certain degree. However, considering the majority of individuals investing in stocks do so with little to no discipline and are seeking short-term gains. The most common negative connotations from the word “stocks” are:

- Too risky
- Gambling
- Confusing

But when the word “business” is used in place of “stock,” these negative connotations seem to fade. Repeat these two questions to immediately notice the difference.

**Are stocks risky?**

**Are businesses risky?**

## Stocks are Risky for Speculators

There are really two types of people who buy and sell stocks:

**1. Speculators**: Those who try to profit from guesses and hunches as well as on the movement of stock prices
**2. Investors**: Those who try to buy great businesses at good prices to realize a gain in the long run

Speculators are not investors at all. This type of person simply focuses on the stock and the price.

They do not know anything about how the company is run, what the company plans are and how well it has been doing.

Investors, on the other hand, focus on the business, just like how a real businessman focuses on day to day operations and tries to maximize the value of his business.

When you read books that suggest stocks are risky, without distinguishing between speculators and investors, the author is either:

1. not aware of the difference between the two or
2. is ignorant of how significantly different they are

When I first learned finance I was taught that investing in individual stocks is risky. It was gambling and you should invest in mutual funds that are highly diversified so you can earn the returns of the market.

To put it bluntly, this is an ignorant understanding of finance and constantly regurgitated without being corrected. The reason people quickly make these assumptions regarding stocks is because they haven't done enough study to realize that speculators and investors are drastically different.

**Benjamin Graham**, often referred to as the Father of Value Investing, was one of the first individuals to make sense out of investing in stocks and squash the myth that stocks are risky.

## What is The True Definition of "Stock Investing"?

Let's look at Graham's definition of investing.

> *"An investment operation is one which, upon thorough analysis, promises safety of principle and an adequate return. Operations not meeting these requirements are speculative." – Benjamin Graham*

If this is true, then anyone who invests without considering what the business is worth is a speculator. There are tools such as the **OSV Stock Valuation Models** that help with valuing the intrinsic value of stocks to identify what a stock is worth.

But let's stop and explain what we mean by some of these investing terms.

**Intrinsic value:** the real value of the business derived from fundamental analysis.

**Fundamental analysis:** the analysis of profitability, tangible assets, and cash flow derived from financial statements, SEC filings, and other facts regarding the business (income statements, balance sheets, and cash flow statements etc.) to assess the intrinsic value of a business.

## Speculator vs Investing Example

Let’s explain this as an example.

If you wanted to buy a rental property you would want to know what you’re buying, right?

If you are a smart investor you would take a look at the neighborhood, history of what renters have paid for rent in the past, history of what renters are paying for houses nearby, the number of rentals that are not occupied nearby, and the tangible value of your house: walls, rooms, fixtures, condition, basement, etc. You would most likely consider many other factors as well.

This is fundamental analysis.

On the other hand, what if you approached buying your rental from a speculative approach? There are many speculative approaches, but let’s consider a few:

1. Buy a rental property based on the fact that the selling price of the property has been rising faster than other houses over the last last 2 years.
2. Buy a rental property because the price is 30% lower than it was last year.
3. Buy a property because you speculate that the city is going to eventually buy the property from you at a high price to develop commercial space for the city.

None of these reasons, by themselves, take into consideration the intrinsic value of the property. And without taking the intrinsic value into consideration, how can you ensure “safety of principle and an adequate return?”

It’s impossible.

## Are Stocks Risky? Not if You Invest.

You need to know the value of what you are buying. Maybe the price has shot up over the past two years, but maybe this was simply because buyers were simply overpaying. Maybe the price is 30% lower this year than it was last, but maybe this was simply because the basement was flooded, severely damaging the foundation of the house. Maybe it is possible that the city will eventually purchase the property for a higher price than what you paid for it, but if it doesn’t, and you never did your fundamental analysis, there is the possibility that you overpaid for the property and could incur a serious loss.

The same goes for stocks. Think of it as if you are buying a business as a whole. You would search for a great business, analyze the facts, and then estimate its intrinsic value.

Then, because of the time value of money and because not everything always goes as predicted

you would only purchase at a discount to fair value, allowing for a margin of safety.

When you buy a stock you are simply buying a share of a business.

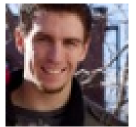
Why then, would you approach the purchase of stocks any differently than the approach of buying businesses as a whole? I doubt it is very often that someone buys an entire business for speculative reasons. They most likely gather all the facts, do fundamental analysis, **calculate the intrinsic value**, and offer to buy the business at a price that seems like they will receive true value for the price they paid to protect their principal and ensure an adequate return.

Investing this way takes discipline and patience.

Most people are satisfied to remain ignorant, keeping it simple: "investing in individual stocks is risky," "mutual funds are diversified and will keep you from loosing your money like you could in stocks," "investing in individual stocks is gambling."

Whether or not investing in stocks is gambling depends on whether or not the investor is a true investor or a speculator.

## About Daniel Sparks



Daniel Sparks is a passionate value investor with a specific interest in behavioral finance and its implications on investing. He is the author and founder of Value Folio, a value investing blog.

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