The 14 Myths About Market Values Cheat Sheet

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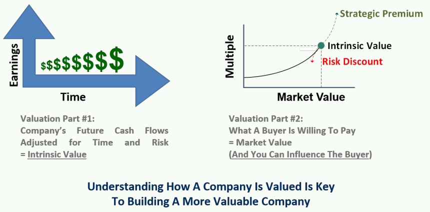
The 14 Myths

1. The market value of an asset or liability is a single number.
2. Assets’ original costs (or liabilities’ original proceeds) equal their market values on the date they’re acquired (or incurred).
3. Users don’t want to know market values.
4. Market values for assets (or liabilities) are irrelevant if management doesn’t plan to sell (or settle) them.
5. Market values are unreliable because they’re hypothetical predictions.
6. Market values can be reliably calculated.
7. Market value information is too costly to update.
8. Unrealized losses are real but unrealized gains are not.
9. Market values cannot be safely audited.
10. Reporting market values makes real income volatile.
11. Reporting market values makes stock prices volatile.
12. Existing generally accepted accounting principles are cost-based.
13. Market value information is not useful for private companies.
14. Market value-based financial statements will never be acceptable.

Intrinsic Value



Buffett 4 Rules

Warren Buffett ensures all four rules are met before purchasing a stock pick:

1. Vigilant leadership
2. Long term prospects
3. Stable and understandable
4. Attractive intrinsic value

Rule 1: Vigilant leadership

Having a great leader is vital for any company, and as a shareholder you want to make sure that your next stock pick is well managed. Warren Buffett knows that the character of the leader trickles down through the organization. In your research of fulfilling the first rule, you should look for a company that has twice as much equity as debt. Think about this as owning a $15,000 car, where at least $7,500 is already paid off.

Rule 1: Vigilant leadership (cont)

Typically, managers that carry low levels of debt are conservative with the capital of the business and don’t risk your money for a desire to grow too fast..

Rule 2 Long term prospects

Warren Buffett only buys stocks in companies that have long term perspectives. The reason is that these companies will continue to make him wealthier over time, but also because capital gains tax must be paid whenever he sells stocks at a profit. That is probably why Warren Buffett is quoted as say that his “favorite holding period is forever”. If this is a little confusing, Preston and Stig made a video about the impact of capital gains on short-term traders (or day traders).

Rule 3 Stable and understandable

To properly value a stock, it must be stable and understandable. Think about the weather in the Sahara. It is hot and sunny and it is probably the same thing 30 years from now. You want the same certainty for a profitable stock pick. When a company’s profits look like a yo-yo, it’s typically impossible to value. If the value you predict for a stock has very little certainty, you effectively have no idea if you’re getting a good deal or not.

As a stock investor you would look for growing or consistent metrics including: earnings, debt, return on equity, and dividends. A good rule of thumb is to look at a 10-year time period for past performance to see if the company is stable. Preston and Stig built a stability calculator to help you graph these metrics and visually see a company’s stability.

Rule 4 Attractive Intrinsic Value

This rule is the first place Warren Buffett looks to determine if a company is a potential buy. By determining an intrinsic value for a company, he can quickly filter out numerous stock picks and only focus his time on a few viable candidates. If he finds out that the price is significantly below the intrinsic value, he might buy it.

This is what Warren Buffett calls margin of safety. Think about it as building a bridge that can withstand the weight of a 10,000 pound truck. Would you build the bridge to withstand a weight of 10,001? Of course not! You would aim for 20,000 pounds. Warren Buffett knows that the same goes for buying stocks.