

VALUATION HIERARCHY

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TOPIC 11 - Valuation Hierarchy

INTRODUCTION AND OBJECTIVE

Often in times, we notice that there are many valuation techniques being used and we also noted that **the outcome of the fair values is affected by the technique chosen**. Some of the techniques chosen require an analyst to use assumptions that are **subjective** in nature and this causes potential subjective views of an analyst being translated into the fair values derived. This may be aggravated if "data mining" is adopted in a valuation report, to achieve a desired fair value. Data mining is a form of bias in ascribing fair value. **by selecting inputs** that meets the desired fair value such as amending the growth rate, cost of equity, weighted average cost of capital, any other inputs, i.e. in simple term **it is a manipulation of the inputs** which are subjective in nature.

Hence, in this article, I intend to share some guidance issued by Global Investment Performance Standards (GIPS), that provides guidelines on choosing a suitable method to be used based on following emphasis:-

- (i) Using **objective inputs** - to reduce the use of subjective inputs by an analyst.
- (ii) **Observable inputs** - Using inputs which are observable in market place.
- (iii) **Inputs used are from active markets** as opposed to inactive traded markets.

Appended in a summarized table for reference. It is noted that the highest hierarchy in the valuation method is based on objective and observable inputs obtained from active markets and the lowest hierarchy have attributes which are the opposites. It should be noted that the guidelines are for reference guidance only and **one cannot claim compliance with GIPS unless one adopt in full the GIPS guidelines** which covers a broad range of areas in guiding the performance reporting of funds.

Valuation hierarchy	Attributes									GUIDANCE ON CHOOSING AN APPROPRIATE MEHTODOLOGY IN EQUITY MARKET PRICING
	Objective	Observable	Quoted market prices	Identical investments	Similar Investments	Active markets	Inactive market	Market based inputs other than quoted market prices	Subjective unobservable inputs	
Section 2(C) GIPS										
1a	✓	✓	✓	✓		✓				Unadjusted price of an asset, if asset is already quoted in an active market, i.e. asset is a traded in an active market.
1b	✓	✓	✓		✓	✓				If asset is not traded in an active market, identify methods to price it by comparing with suitable similar investments that are traded in an active market. Seems more applicable to derivative instruments.
1c	✓	✓	✓		✓		✓			If asset is not traded in an active market, identify methods to price it by comparing with suitable similar investments that are traded in an inactive market. Seems more applicable to derivative instruments.
1d						✓		✓		Using some form of pricing e.g. discounted cash flow and use the inputs that could be derived from market, e.g. implied input parameters from tradable instruments to derive the value of inputs to be used or using some form of Relative Valuation Analysis based on market inputs.
1e							✓		✓	Using some form of pricing e.g. discounted cash flow and use the inputs by professional subjective assessment.

THANKS FOR READING.

This article is prepared by Ong Tee Chin, CFA, FRM, and represents the view of the author. He can be contacted at ong@atlantiscapital.org for any further enquiries on the contents of this article. The author wishes to declare that this article is not sponsored by any party and it is solely prepared of the author with aim to share knowledge with readers having common interest.

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