Book Review for 5/30/04 by David Coffee

Title: “Financial Statement Analysis and Security Valuation”
Author: Stephen H. Penman
Publisher: Irwin
Length: 739 pages
Price: $139.90
Reading time: 38 hours
Reading rating: 3 (1 = very difficult; 10 = very easy)
Overall rating: 3.8 (1 = average; 4 = outstanding)

It is not the normal practice to review college textbooks in this review series. But Stephen H. Penman’s award winning “Financial Statement Analysis and Security Valuation” is not the typical financial analysis textbook and has appeal beyond the classroom. If you are an investor in the stock market with curiosity about how analysts use financial statements to derive an estimate of the value of a stock (referred to in the industry as fundamental analysis) then I strongly recommend investing in this book. Yes, for those not in the know, college textbooks are expensive, and no, you do not need a strong accounting background to benefit from the book, although familiarity with financial statements will help.

Steve Penman’s expertise is in the valuation of equity and the role of accounting information in security analysis. With an M.B.A. and Ph.D. from Chicago, and professorships at Berkeley and Columbia, Penman is deeply immersed in academe. Penman received the American Accounting Association and Deloitte & Touche Wildman Medal for this book. But the books real appeal is its usefulness, readability and utility to the active investor.

Penman characterizes two kinds of investors: active and passive. The passive investor assumes the market is efficient and that stocks are correctly priced to reflect the risk involved in buying the stock. The active investor, to whom the book is directed, calculates his or her own value based on the analysis of information contained in the financial statements. This valuation is referred to as intrinsic value and it is compared to the market value at which the stock is trading, to form the basis of an investment decision.

Penman helps the reader distinguish between momentum investing and investing on the basis of fundamental analysis. He details the market bubble of the 90s and the subsequent discovery that financial statements do matter, and they do in fact serve as the platform upon which to calculate the intrinsic or true value of an equity security.

The book demonstrates how to take basic information from financial statements and apply this information to various valuation models to arrive at an estimate of the intrinsic value of a stock. True, most of us, myself included, are inclined to let the professional security analysts handle this and take their numbers. But learning to make these calculations yourself may indeed be worth while for the active investor, as he will learn that some growth assumptions supporting estimates of valuation are unrealistic. Those of us who went through the bubble know this all to well.

The book illustrates at least seven different valuation models. While I will not try to summarize them here, all are understandable and fairly straight forward, if the reader is willing to invest a little effort.

If such modeling is not of interest, you may still find the book useful. It is chucked full of historical insights on market statistics. One of particular interest is research being done at the Parker Center at Cornell. Here professors have calculated the intrinsic value of the DOW from 1979 through March 2004. They compare this intrinsic value (the true value of the DOW based on their valuation model) with market value. During the bubble of the late 90s, market price was as much as 2.8 times intrinsic value. Currently market value is below intrinsic value, measuring only about .7 of intrinsic value. Every time market value has fallen this low relative to intrinsic value (five times since 1979) the DOW has performed strongly over the next couple of years. If interested you can find the Parker Center Web site at:
http://parkercenter.johnson.cornell.edu/research_highlights_dow30.htm

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