How Much Credence Should Investors Give Price Targets?

Description

Investors considering whether or not hard-earned dollars should be put into an investment vehicle search high and low for every piece of information that may refute or support their underlying investment thesis.

Investors will look at the fundamentals of the underlying business, growth trends, industry and macroeconomic data, technical indicators, and various other metrics to assess the worthiness of a particular investment.

I'm going to discuss two additional pieces of information often looked at by investors: price targets and insider buying/selling trends.

Price targets

Depending on the company, analysts from a variety of firms will provide analysis on a given company, each providing an independent price target based on the firm's own financial model and assumptions.

These financial models take input data (typically historical data) and extrapolate or forecast this data into the future. The assumptions made and models used will vary greatly, leading to differing target prices among various firms which can, in some cases, deviate significantly from each other.

The financial models used to come up with a target price for a given stock essentially attempts to calculate what the net present value of all future cash flows will be for a firm. At its core, the model provides investors the price a stock should be, if all future cash flows are discounted to today's price.

As these calculations result in a stock price which many could say is "priced to perfection," the target price for a given stock will tend to be higher (in some cases, significantly higher) than the current stock price.

Investors are, on the whole, rational in their interpretation of information. Analysts with varying models typically can paint a pretty good picture of the growth prospects of a company moving forward, and the correlation between target prices and actual prices over time tends to be statistically significant.

That said, every model is based on assumptions, and investors will need to draw their own independent assumptions about the company's fundamentals and growth prospects to truly find an appropriate entry point for a given stock.

Earnings quality vs. earnings growth

In attempting to value an equity position, investors should differentiate between earnings quality and earnings growth. The earnings numbers one is able to pull off of Google Finance or Yahoo Finance show only part of the story; the growth (or lack thereof) of a company's earnings is only one half of the calculation of where a company is headed.

Earnings quality is an independent metric of growth, and investors should ascribe some sort of discount or premium to the trailing fundamentals of a company based on the quality of the underlying business's revenues and earnings.

As an example of a company I have attributed an earnings-growth premium to is **Algonquin Power & Utilities Corp.** (TSX:AQN)(NYSE:AQN). This utilities company has a number of unique factors driving the business forward.

It is one of only a few firms with scarce water utilities assets which have outperformed, and it provides Canadian investors with unique access to this industry, giving Algonquin a scarcity premium as well as a premium for earnings quality.

Bottom line

Determining which companies are better than others can be difficult, and investors will need to ascribe premiums or discount the value of particular stocks based on their analysis and overall investment thesis. Taking these numbers at face value can be a dangerous game. One of the greatest assets I believe an investor can have is an independent mind.

Stay Foolish, my friends.

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2. TSX:AQN (Algonquin Power & Utilities Corp.)

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