10 everlasting truths in finance

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1. Divorce is not allowed in the Risk-Return pair

In %	2001	2002	2003	2004	2005	2006	2007	2008	2009
Return on equity UBS investment banking division	6%	9%	25%	26%	29%	29%	- 63%	- 128%	- 124%

The higher the return the higher the risk incurred.

A higher return without a higher risk incurred is a mirage. Sad but compelling!

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2. Over the long term, ROCE converges towards WACC

Michelin, the world leader in tyres.

	2000	2002	2004	2006	2007	2008	2009
Return on capital employed	6%	7%	8%	7%	10%	5%	4%
Weighted average cost of capital	7%	7%	8%	7%	8%	10%	8%

Why? Competition

All the more time if it is a mature company.

3. Debt does not create value per se

Except when:

- interest rates are negative after inflation (lenders are despoiled). See Europe and the USA in the 60s and the 70s.

- debt put pressure on managers to out-perform. Source of value creation for LBOs.

4. Cash is king

- Because a company goes down if it is lacking cash.
- Because a liquidity crisis represents a unique opportunity to buy assets on the cheap.
- Because cash is truth. Mr. Madoff would still be in business if he had not some minor cash issues end of 2008.
- Because the easiest way to solve complex financial problems is to analyze them in term of cash flows.

5. EV / CE > 1 <=====> ROCE / WACC > 1

The entreprise value (EV) of a company can only be higher than its capital employed (CE) if its return on capital employed is anticipated for several years to be higher than its weighted cost of capital (WACC).

	WACC	ROCE	EV / CE
Apple	10%	318%	44
L'Oréal	7%	18%	4
X5	12%	16%	3
RBS	11%	-3%	0.8

6. Diversification *per se* does not create value

- In most emerging markets, conglomerates are the rule of the game as financial markets are not well developped and conglomerates are a substitute for them (internal capital markets).

- Diversified groups allow founding entrepreneurs / families to keep control and to diversify their wealth.

- On a long-term basis a diversified group can only survive if it demonstrates that nobody can manage its assets better than itself: e.g., General Electric, Bouygues.

  Counter examples: Hanson, BTR, ITT, Gulf and Western, Lagardère, etc.

7. WACC is only a function of the risk of operating assets

- The weighted average cost of capital (WACC) is the weighted average cost of debt and equity, weighted by the respective share of debt and equity in the capital structure of the company.
- Increasing the debt weight whose cost is below that of the equity (because it is less riskly for investors) does NOT reduce the WACC.
- Most of the time it increases the ROE, and systematicaly the risk of the capital structure of the company.
- If debt had the power to reduce WACC, the most successful companies in the world would be debt loaded.
- Most of them are debt free: Apple, L'Oréal, BMW, etc.

8. Accounting is not finance

- Finance does take into account the future and hence risk, contrary to accounting which limits itself to the past and the present and ignores risk.

- Which means that indicators that seems to be financial but in fact come from accounting like Earnings Per Share (EPS), Return On Equity (ROE), can be manipulated: an increase in EPS or ROE does not necessarily translate into an increase in value if it is explained by an increase in the riskiness of the activity or the capital structure.

9. Beware of tax fascination

- Taking financial decisions guided only by tax considerations is a recipe for disaster.

  For example keep on holding shares a few more months so as to get a tax break because the holding period would be long enough expose you to the risk of a market crash in the meantime.

- Granted there are more pleasant things in life than paying taxes.

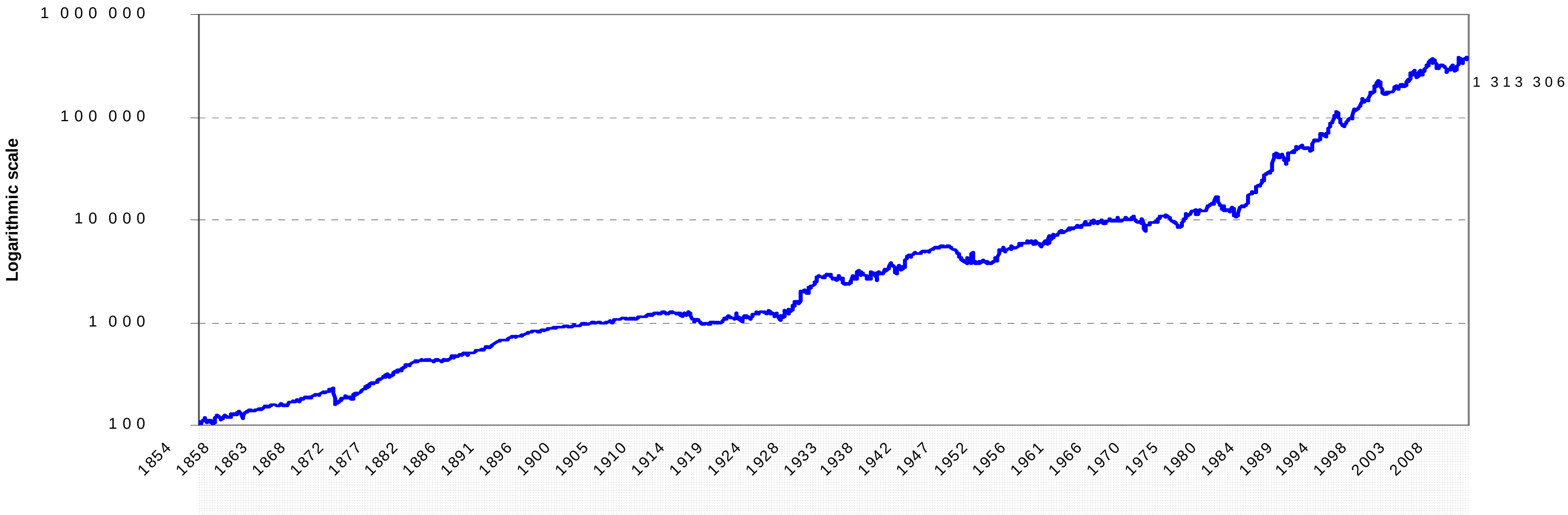
- Better to take a financial decision and **then** try to optimize tax parameters.

10. The only efficient regulator for capitalism is crisis

We are all human beings with feelings like hope and fear that regularly translate into booms and busts. There is nothing we can do about that.

There have always been crises in the past.

Paris Stock Exchange index since 1854 (dividends reinvested)



Source : Le Bris David et Hautcoeur Pierre-Cyrille.

They will be there in the future too. Investors and managers need to keep that in mind and act accordingly.

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