FROM THE EDITOR

Why All the Fuss about Total Beta?

The Value Examiner continues to receive a multitude of article submissions and letters to the editor on the topic of Total Beta (Tβ) and company-specific risk quantification.

In this issue we have Larry J. Kasper's article, "Portfolio Theory and Total Beta—A Fairy Tale of Two Betas" (page 26). Peter J. Butler's response to Kasper's article appears on page 38.

ROOTS OF THE DEBATE

The controversy began with the application of Professor Damodaran's "total cost of equity" (TCOE) formula in the Butler-Pinkerton Calculator. After decades of having to literally guess at what company-specific risk premium would be most appropriate for a given firm or asset, the B-P Calculator, for the first time, promised an analytical solution to this problem. The B-P Calculator output is based upon finding suitable total risk proxies in the public markets. Little wonder, then, that so much attention has been devoted to the B-P Calculator, Total Beta, and the issue of company-specific risk quantification. To some, the B-P Calculator represented the light at the end of the tunnel. To others it only signaled the approach of some very misguided thinking. The profession remains strongly divided on the issue.

At the extremes, we are likely to find the Traditional Portfolio Theorist at one end and the Total-Risk-Compensated Modernist [for lack of a better moniker] at the other. The traditional theorist believes there is no need to calculate a rate of return for company-specific risk because these risks can be diversified away. Therefore the markets will not reward the individual investor for bearing these risks unnecessarily. The modernist, in contrast, believes that an investor will demand a return for *all* of the risk he or she will be exposed to, and if that investor happens to be largely undiversified (as would often be the case for an owner-manager purchasing the controlling interest in a private firm), then company-specific risk becomes an unavoidable risk *to that specific investor*—so he or she would then naturally demand an appropriate risk-adjusted return on the company-specific (also called idiosyncratic or non-systematic) risk to which he or she will be exposed.

The problem becomes a vexing one for the profession because we are not often responsible for coming up with an asset value to a *specific* investor. Instead we are usually concerned with the value to the hypothetical (often the marginal or notional or typical) buyer. On the other hand, if it can be shown that the universe of potential bidders on any given asset would most likely be exclusively comprised of undiversified owner-managers, then it is entirely appropriate to presume that the marginal bidder is undiversified.

Some *Value Examiner* contributors have suggested that a compromise between the two extremes was the best way to go. In other words, the fully diversified investor belonged in the domain of the public markets, where company-specific risk could be easily diversified away; and the TCOE was the proper measure of risk in the private equity markets, where it was more likely that the ultimate purchaser was less diversified than traditional portfolio theory would demand. At first blush, this conciliatory approach seemed to have a lot going for it, but ultimately it must be abandoned for its inherent flaws. For one thing, the B-P Calculator only works because it is drawing on risk proxies from the public markets. So if you steadfastly believe that all the company-specific risk is priced out of the public markets by diversified investors outbidding the very few undiversified buyers, then the B-P Calculator would never report a TCOE that was significantly different from that of CAPM (note that TCOE = CAPM + CSRP). Systematic risk returns would dominate the public markets, and the additional CSR measured by BPC would be insignificant.

Editor's note: This guest editorial was written by Richard R. Conn, CMA, MBA, CPA/ABV, CFFA, a member of *The Value Examiner* Editorial Board. To submit your comments, please contact David M. Freedman, Sr. Editor, davidf1@nacva.com.

This is not, however, what we typically observe in the public markets where the majority of historic price volatility can be attributed to non-systematic, rather than systematic causes. (See, for example, my article in the Sept/Oct 2011 *Value Examiner* titled "A Primer on the Nature of Idiosyncratic Risk and Volatility.") Secondly, it is mere speculation at this point to generalize that private equity purchasers demand a return on CSR while public market purchasers do not. The private markets are veiled in secrecy and suffer an almost complete absence of any form of historic volatility data—so there is no verifiable means of segregating the types of risk priced in the private equity markets.

TRADITIONALIST AND MODERNIST

Realistically, both the traditional portfolio theorist and total-risk-compensated modernist are unavoidably handicapped. The traditionalist will usually advance the argument that total risk pricing methodologies (such as Total Beta and TCOE) will not reconcile with the formulas of modern portfolio theory. This is not surprising, however, because modern portfolio theory and particularly CAPM were advanced as a means of measuring *only* systematic risk. So, pointing to the fact that total risk approaches do not accord with modern portfolio theory, which was never intended to measure non-systematic risk, does not advance our understanding much. On the other hand, those innovators attempting to devise new methods of objectively quantifying total risk do so with surprisingly little empirical evidence. It is astounding to me that a full 60 years has passed since Markowitz first published "Portfolio Selection," and yet we still know very little about how the markets (public or private) price non-systematic risk. TCOE, for example, works under the presumption that the reward-rate-per-unit-of-volatility is the same for both systematic and non-systematic volatility, but there is no credible empirical study, to my knowledge, that would support this hypothesis.

The TCOE/company-specific risk debate continues vociferously and, in my view, it has been a tremendous benefit for the profession at large. It has caused us to question the applicability of long-standing tenets of finance to the pricing of individual closely held assets. It has also highlighted and brought attention to the new ideas of many gifted academics and professionals who are focused upon coming up with a better solution than the status quo. And, most importantly, it has proven that the business valuation profession is open to self-criticism and unwaveringly dedicated toward improvements and advances.

Larry Kasper's article on page 26 is more than just another criticism of Total Beta. Rather, he attempts to show that the private-company Beta, an effort by Butler & Schurman[1] to introduce partial diversification into the theory of TCOE, is inherently flawed.

The Value Examiner remains committed to the advancement of new ideas that benefit the profession, and welcomes comments and suggestions on all magazine content. We encourage readers with opposing views of the TCOE/CSR perspectives published in this or earlier issues to share their ideas with the profession at large and submit a formal article for peer review. VE

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1 See Peter J. Butler and Gary Schurman, "A Tale of Two Betas," *The Value Examiner*, Jan/Feb 2011, pg 21.