Should Fiduciaries Use NPV?

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Comparing the Net Present Value (NPV) of a public company with its market capitalization is one of the most rigorous and reliable methods for assessing whether a stock is overvalued or undervalued.

However, calling it the single most accurate method may overstate its exclusivity, because no single metric alone is infallible—especially in the complex world of financial markets.

Why NPV vs. Market Cap is a Powerful Tool for Fiduciaries

1. Mathematically Grounded in Future Cash Flows
   - NPV is a fundamental valuation metric that discounts expected future free cash flows (FCFs) to the present, ensuring that valuation is based on real projected earnings rather than speculative assumptions.
2. Directly Compares Intrinsic Value to Market Price
   - If the company's market cap significantly exceeds its NPV, it suggests overvaluation and a higher probability of price declines.
   - If the market cap is below its NPV, it suggests undervaluation, offering a better risk-adjusted opportunity.
3. Anchors Analysis in Rational, Long-Term Decision Making
   - Unlike relative valuation methods (P/E, P/S), which depend on market sentiment and peer comparisons, NPV is independent of market noise.
   - It prevents fiduciaries from making investment decisions based on hype, momentum, or misleading short-term earnings boosts.
4. Fulfills Fiduciary Duty of ‘Care’ and ‘Loyalty’
   - The SEC’s fiduciary duty of care requires advisors to base investment decisions on "reasonable inquiry" and "diligence."
   - Using a forward-looking valuation metric like NPV ensures that investments are selected based on their long-term financial sustainability rather than short-term speculation.

Limitations of NPV vs. Market Cap as a Standalone Tool

While incredibly powerful, NPV is not flawless by itself:

1. NPV is highly sensitive to assumptions
   - A small change in discount rate or growth assumptions can materially affect the valuation.
   - Misestimating future FCFs can lead to false signals.

2. Market sentiment and external risks impact stock prices
    - Market caps can temporarily deviate from NPV due to macroeconomic factors, liquidity, or investor behavior.
3. Accounting for debt and risk factors
    - A company with high leverage may have an NPV that appears attractive, but debt risks make it unsafe.
    - Other metrics like tangible equity growth and debt levels must be factored in.

Conclusion: The Most Reliable Framework

- NPV vs. Market Cap is among the most robust valuation methods fiduciaries can use to honor their duty of care.
- However, the best approach integrates multiple factors:
    - NPV-to-market cap ratio
    - Historical valuation comparisons (e.g., P/S, P/E trends)
    - Debt levels and cash flow stability
    - Competitive positioning and industry risks

For fiduciaries, using NPV as the cornerstone of valuation—while incorporating supporting risk factors—creates the strongest investment discipline to protect clients from overpaying for stocks and from catastrophic losses.