

[Summary]

Market Efficiency (Part-2) Subject:

Business Economics

Course:

Undergraduate

Paper No. & Title:

Paper – 511 Investment Management

B. A. (Hons.), 5th Semester,

Unit No. & Title:

Lecture No. & Title:

Unit – 2 Market Efficiency

Lecture – 2 Market Efficiency (Part-2)

Summary:

The dividend discount model is a useful model that relates the present stock price to the present value of its future cash flows. The dividend discount model depends on projections about company growth rate and future capitalization rates of the remaining cash flows. For instance, in a bear market, the capitalization rate will be higher than in a bull market—investors will demand a higher required rate of return to compensate them for a perceived greater amount of risk. Getting either the capitalization rate or the growth rate wrong will yield an incorrect intrinsic value for the stock, especially since even small changes in either of these factors will greatly affect the calculated intrinsic value. Furthermore, the greater the length of time considered, the more likely both factors will be wrong. Hence, the true intrinsic value of a stock is unknowable, and, thus, it cannot be determined whether a stock is undervalued or overvalued based on a calculated intrinsic value, since different investors will have a different opinion about the company's future.

Price-to-Earnings ratios are particularly useful in making immediate comparisons and superficial analysis as well as its limitations. Despite of whatever limitations of the P/E ratio, the investment community makes extensive use of this valuation metric. Investors considering a stock purchase compare the current P/E ratio against the stock's long-term (three to five years) historical record to reach to a logical conclusion.