Price as PDV of Expected Dividends

- If earnings equal dividends and if dividends grow at long-run rate g, then by growing consol model $P=E/(r-g)$, $P/E=1/(r-g)$. (Gordon Model)
- So, efficient markets theory purports to explain why P/E varies across stocks
- Low P/E does not mean that the stock is a "bargain," it only means that earnings are rationally forecasted to decrease in future
- Efficient markets denies that any rule works

Reasons to Think Markets Ought to Be Efficient

- Marginal investor determines prices
- Smart money dominates trading
- Survival of fittest