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 in terms of *r* and *g*
- Low P/E does not mean that the stock is a “bargain,” it only means that earnings are rationally forecasted to decrease in future (low g) or that risk is high (high *r*)
- Efficient markets denies that any rule works other than simple diversification
- Value investing says invest in low *P/E*

Evidence of Feedback Mechanism: Results of Individual Investor Survey: Stocks are the Best Investment