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A Theory of Price-Earnings Ratios*

NICHOLAS MOLODOVSKY

ACCORDING TO A SHOPWORN ANECDOTE, Morgan the Elder, when asked for an opinion concerning the outlook for the stock market, quipped that stocks will fluctuate. This pronouncement from the throne of financial success and power is frequently quoted as an irrefutable dictum condemning, with sarcastic brevity, ill-guided attempts by the ignorant or the presumptuous to predict the unpredictable. And this ironic verdict is sometimes construed to imply a general sweeping denial that stocks obey any law or serve any sovereign.

Most analysts of common stocks will not subscribe to the latter view. Stocks will fluctuate. But they move around a computable value. Temporarily they sway from it, but always return. They remain bound by gravitational force to that sun of the economic system.

DIVIDENDS THE CENTER

Dividends form the hard core of stock values. As Justice Holmes remarked, "the commercial value of property consists in the expectation of income from it."[1]

At first glance it may seem that the value of a common stock is not necessarily related to future dividend payments. The typical investor is looking for both dividends and capital appreciation. Few invest for income alone. Sometimes investors in high-income tax brackets avoid income payments, especially if they happen to be substantial. They try to aim instead for long-term capital gains. And they seek out stocks of companies habitually retaining large proportions of profits. Numerous stocks paying small or no dividends often command high prices. However, the expectation of future payments is the active force that supports them.

Imagine, for example, the extreme and purely hypothetical case of a corporation controlling considerable wealth, but prohibited by its by-laws from paying any dividends, in either money or stock, and whose charter has a clause enjoining it from voluntary liquidation. The setup of this "Frozen Corporation"[2] would run counter to established public policy. But, if we assume that it exists, all the realized profits would necessarily be reinvested in the business itself. It might flourish. In its successive reports, its growth could look impressive. However, Frozen common will have value and command a price only as long as potential buyers hope that its property will eventually be sold. They would then have the benefit of substantial liquidating payments or, through an exchange of stock, begin to receive dividends all the larger because of the great reinvestment of earnings. They might perhaps gamble also on the expectation that Frozen Corporation will be subject to stockholders' suits for a change of its by-laws. Each time a new director was elected, there would be rumors that the by-laws were to be amended. At such moments, Frozen would emerge as a speculative leader.

But, as we are free to deal at will with this figment of our imagination, we could insert a clause prohibiting both the sale of the property and amendment of the by-laws. That would effectively seal the fate of Frozen common. By extinguishing all hope of future payments it would be rendered completely worthless despite the enormous assets behind it.

RULE OF PRESENT WORTH

The concept that the value of a stock depends on future dividend payments erects an apparently impregnable barrier. Investors stand before the immensity of the indefinite future. They must be able to envision, separately and jointly, throughout all the years of the entire future corporate existence, all the dividends to be paid by the companies whose stocks they are appraising.

As time marches on, payments of dividends are heaped upon payments. If this condition had no internal limitations, an investor buying stocks, say forty years ago, should have been then paying much higher prices than any that have since prevailed. If he were still holding these stocks, he would continue to be entitled to all the dividends to be distributed on them in the future. And, in addition, he would have in the meantime enjoyed all the previous dividends that had been paid in the past but can no longer be available to present-day buyers. From the point of view of a buyer of forty years ago, today's values are truncated because all the dividends of the past are water over the dam.

Seen in this perspective, investors should be richer by holding stocks at the depth of a severe depression than by holding the same stocks at the pinnacle of a subsequent bull market. The future, even though undisclosed, is eternally present and is not subject to enlargement, while each year that passes chops off a chunk of wealth. It could be argued that values suffer a constant process of erosion and that stock prices should follow a pronounced long-term declining trend.

To preserve them from so bleak an outlook, the rule of the present worth of future payments comes to their rescue. For an investor, buying stocks forty years ago, that is, in 1913, each dollar of dividends paid today, discounted at compound interest of 6%, would have been worth less than a dime. And 6% was considered at that time a normal stock yield and an economically justified claim on the part of an investor for return on his capital.

The concept of present worth is one of the pillars of the economics of finance. Present goods command a premium over future goods. The wealth of today will not be exchanged at par for the expected wealth of the future. The

*The author is indebted to Miss Catherine May for drawing the charts and making the computations used in this study. To the friendly experts who have read and criticized this report he is most grateful.

[1] References appear at the end of the article.

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