

The Myth of the Earnings Yield

By Sam Vaknin, Ph.D.

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Abstract

A very slim minority of firms distribute dividends. This truism has revolutionary implications. In the absence of dividends, the foundation of most - if not all - of the financial theories we employ in order to determine the value of shares, is falsified. These theories rely on a few implicit and explicit assumptions:

That the (fundamental) "value" of a share is closely correlated (or even equal to) its market (stock exchange or transaction) price;

That price movements (and volatility) are mostly random, though correlated to the (fundamental) "value" of the share (will always converge to that "value" in the long term);

That this fundamental "value" responds to and reflects new information efficiently (old information is fully incorporated in it).

Investors are supposed to discount the stream of all future income from the share (using one of a myriad of possible rates - all hotly disputed). Only dividends constitute meaningful income and since few companies engage in the distribution of dividends, theoreticians were forced to deal with "expected" dividends rather than "paid out" ones. The best gauge of expected dividends is earnings. The higher the earnings - the more likely and the higher the dividends. Even retained earnings can be regarded as deferred dividends. Retained earnings are re-invested, the investments generate earnings and, again, the likelihood and expected size of the dividends increase. Thus, earnings - though not yet distributed - were misleadingly translated to a rate of return, a yield - using the earnings yield and other measures. It is as though these earnings WERE distributed and created a RETURN - in other words, an income - to the investor.

The reason for the perpetuation of this misnomer is that, according to all current theories of finance, in the absence of dividends - shares are worthless. If an investor is never likely to receive income from his holdings - then his holdings are worthless. Capital gains - the other form of income from shareholding - is also driven by earnings but it does not feature in financial equations.

Yet, these theories and equations stand in stark contrast to market realities.

People do not buy shares because they expect to receive a stream of future income in the form of dividends. Everyone knows that dividends are fast becoming a thing of the past. Rather, investors buy shares because they hope to sell them to other investors later at a higher price. In other words, investors do expect to realize income from their shareholdings but in the form of capital gains. The price of a share reflects its discounted expected capital gains (the discount rate being its volatility) - NOT its discounted future stream of income. The volatility of a share (and the distribution of its prices), in turn, are a measure of expectations regarding the availability of willing and able buyers (investors). Thus, the expected capital gains are comprised of a fundamental element (the expected discounted earnings) adjusted for volatility (the latter being a measure of expectations regarding the distribution of availability of willing and able buyers per given price range). Earnings come into the picture merely as a yardstick, a calibrator, a benchmark figure. Capital gains are created when the value of the firm whose shares are traded increases. Such an increase is more often than not correlated with the future stream of income to the FIRM (NOT to the shareholder!!!). This strong correlation is what binds earnings and capital gains together. It is a correlation - which might indicate causation and yet might not. But, in any case, that earnings are a good proxy to capital gains is not disputable.

And this is why investors are obsessed by earnings figures. Not because higher earnings mean higher dividends now or at any point in the future. But because earnings are an excellent predictor of the future value of the firm and, thus, of expected capital gains. Put more plainly: the higher the earnings, the higher the market valuation of the firm, the bigger the willingness of investors to purchase the shares at a higher price, the higher the capital gains. Again, this may not be a causal chain but the correlation is strong.

This is a philosophical shift from "rational" measures (such as fundamental analysis of future income) to "irrational" ones (the future value of share-ownership to various types of investors). It is a transition from an efficient market (all new information is immediately available to all rational investors and is incorporated in the price of the share instantaneously) to an inefficient one (the most important information is forever lacking or missing altogether: how many investors wish to buy the share at a given price at a given moment).

An income driven market is "open" in the sense that it depends on newly acquired information and reacts to it efficiently (it is highly liquid). But it is also "closed" because it is a zero sum game, even in the absence of mechanisms for selling it short. One investor's gain is another's loss and all investors are always hunting for bargains (because what is a bargain can be evaluated "objectively" and independent of the state of mind of the players). The distribution of gains and losses is pretty even. The general price level amplitudes around an anchor.

A capital gains driven market is "open" in the sense that it depends on new streams of capital (on new investors). As long as new money keeps pouring in, capital gains expectations will be maintained and realized. But the amount of such money is finite and, in this sense, the market is "closed". Upon the exhaustion of available sources of funding, the bubble tends to burst and the general price level implodes, without a floor. This is more commonly described as a "pyramid scheme" or, more politely, an "asset

bubble". This is why portfolio models (CAPM and others) are unlikely to work. Diversification is useless when shares and markets move in tandem (contagion) and they move in tandem because they are all influenced by one critical factor - and only by one factor - the availability of future buyers at given prices.

Sam Vaknin is the author of "Malignant Self Love - Narcissism Revisited" and "After the Rain - How the West Lost the East". He is a columnist in "Central Europe Review", United Press International (UPI) and ebookweb.org and the editor of mental health and Central East Europe categories in The Open Directory, Suite101 and searcheurope.com. Until recently, he served as the Economic Advisor to the Government of Macedonia.

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The 10 Myths of Successful Selling

By John Mitchell

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Myth #1 You should close early and often

Myth #2 Sell features to get a higher price

Myth #3 There's no methodology to selling - it's pure art

Myth #4 Objections are a sign of customer interest

Myth #5 Open questions are better than closed questions

Myth #6 You can't teach a person to sell

Myth #7 You have to understand the difference between wants and needs

Myth #8 Great products sell themselves

Myth #9 Making a benefit statement is the best way to open a sales call

Myth #10 All customers make up their minds in the first 4 minutes

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John Mitchell is President and CEO of Inclusive, a company providing sales and marketing outsourcing in the UK and USA. He was a top performer in IBM sales for 5 consecutive years; Chief Marketing Officer of a Fortune 500 company; and CEO of a NASDAQ listed consulting company. John has written for the London Economist and has been guest lecturer at NYU, London Business School and Swiss Banking School.

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