The 1-2-3 of Investing
Part 8: Market Price versus Intrinsic Price

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In an earlier segment of this series, it was suggested that stocks have two prices which can be quite different. One is the *market price* that results from the interaction of millions of investors worldwide, and the other is the *intrinsic price* that is derived from various models that establish the current worth based on future dividends and other factors. Differences between those prices can create profit opportunities.

Imagine a stock that is trading at $25 per share, but a model projects a value of $27.50. One immediate implication is that the stock is underpriced by the market and that the purchase of the shares at $25 would produce a profit when the market price is corrected upward. If the model price had been $22.50, the investor would reason that the stock is overpriced and that a short sale[1] would prove profitable when the market corrects its price downward.

Market prices result from the interaction of a myriad of investors acting on all available information – at least that's what the theory of market efficiency assumes. While investors may number in the millions, the belief that all relative information lies open is sketchy. Opportunities for quick profits have always existed for investors who gain access to information of which the public is unaware. If market prices have holes, how can model prices be faulted?

[1] A short sale means that an investor's account is credited with the sale's proceeds which he/she will repay with presumably a lesser amount.

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The earliest efforts to predict stock prices involved solving for the present value of future dividends. Illustratively, if a stock paid a dividend of $2 until the company quits business after 25 years, a discount rate of 12% would generate a current value of $15.68 – or $2 *times* an annuity present value factor of 7.84. (Readers who take undergraduate courses such as "Principles of Finance" or "Investments" will perform this very exercise.) While a stock's dividends may be predictable, the appropriate return required by investors from that stock can be elusive. If those dividends had been discounted at 10% instead of 12%, the present value model would arrive at a price of $18.16 – that is, $2 *times* 9.08.

Changing the length of an investor's holding period will also create different prices for the same stock. For example, if the company never goes out of business and the stream of dividends never ends, discount rates of 12% and 10% will result in prices of $16.67 and $20, respectively. In finance classes, the negative relationship between rates and dollars is stressed. Greater rates of return require lower stock prices just as lower returns mate with higher prices.

At this point, I would like to share a personal experience. When your writer used a model for his doctoral dissertation, he found that it produced prices for securities that were more correct than the corresponding market prices. The proof was that buying what was underpriced (model price < market price) and selling what was overpriced (model price > market price) led to extraordinary returns. In sum, it might be said that return is not only a function of risk but opportunism as well.