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PERSPECTIVES

Gauging Market Expectations?

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Jan 29, 2021

A recent flurry of return spikes for a handful of US stocks has captivated investors and noninvestors alike. Wall Street news trending on social media even amid an NFL playoff season is indeed an unusual event.

So, what should investors make of these dramatic price movements? A good place to start is with prices themselves. Prices reflect discount rates applied to the expected future cash flows of companies. One can interpret these discount rates as the expected return demanded in aggregate by market participants to hold shares of a company.

Discount rates for a stock incorporate a potentially massive number of viewpoints about the company. Equity markets processed over $653.4 billion worth of trades on an average day in 2020. The result of such activity is prices reacting to a vast amount of information relevant to discount rates.

The link between prices and expected future cash flows through discount rates gives us a framework for interpreting changes in prices. If a stock's price goes up, either expectations of cash flows have gone up or the discount rate went down. In the case of the latter, a stock price moving higher means lower expected returns.

Aggregate demand for securities, and therefore discount rates, can be driven by many variables. Investors may assess a company's exposure to myriad risks, such as sensitivity to macroeconomic variables (inflation, interest rate changes, GDP growth, etc.), its volatility, and susceptibility to regulatory changes, just to name a few. The riskier the investment, the higher the discount rate.

But investor tastes and preferences also play a role in setting discount rates for securities. If market participants prefer one company over another, the rate of return demanded to hold that company's stock may be lower than another stock for that reason alone. This effect is analogous to color preferences of car buyers; if enough shoppers are averse to primary colors, you may be able to get a relative discount on that new, bright-yellow car!

Nearly a century of empirical data tells us that we can use market prices to systematically identify stocks with higher expected returns. This approach is indifferent to the specific considerations driving differences in discount rates. And the evidence for relying on market prices spans a history of different economic environments, market infrastructure evolution, and regulatory changes.

What hasn't generally benefited investors is attempting to outguess markets and identify mispriced securities. The degree of difficulty in anticipating market movements more quickly and effectively than the millions of other market participants is consistent with the paucity of professional investment managers that have been able to outperform passive benchmarks. For investors, this means time is probably better spent scrolling past the news on stock price spikes and going back to arguing about who will win the Super Bowl.

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