5.6: Key Takeaways

Key Takeaways

The US stock market represents a total market capitalization as of 2020 of over $36 trillion and is about 86% larger than the US GDP. Prices for individual stocks range from relatively small (you can buy a share of Blue Apron for about $6.00 as of Janury 2021) to very large (a single share of Berkshire Hathaway Class A costs over $343,000 as of the same date). Since stocks represent an ownership claim on corporations, how do investors determine the fair value for each share? The answer is that stocks, like other financial securities, generate cash flows for their owners over time. Thus, the fair value of a share of stock is simply the present value of all expected cash flows that the stock will generate over its lifetime, discounted back to today at the appropriate risk-adjusted discount rate. What make this difficult is that the expected cash flows are not known and the lifetime is potentially infinite. Therefore, investors need to make assumptions about future growth rates and apply them to valuation models to determine prices. It is essential to note that the true underlying value of a stock is unknowable, and these models only provide approximations that are as accurate as our underlying assumptions. According to the Efficient Markets Hypothesis, the best estimate of the true value of a stock is that stock's current market price. This is due to the current market price being the consensus of all individual attempts to determine the correct value.