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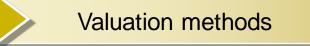
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Dividend valuation model:

The dividend valuation model is based on the theory that an equilibrium price for any share (or bond) on a stock market is:

- The future expected stream of income from the security
- Discounted at a suitable cost of capital

MV (ex div) = 
$$\frac{D}{1+k_e} + \frac{D}{(1+k_e)^2} + \frac{D}{(1+k_e)^3} + \dots = \frac{D}{k_e}$$

Dividend growth model can also be used

Assumptions in the dividend valuation model:

- Investors act rationally and homogenously.
- The current year's dividend (Do figure) does not vary significantly from the trend of dividends.
- The estimates of future dividends and prices used, and also the cost of capital are reasonable
- Investors' attitudes to receiving different cash flows at different times can be modelled using discounted cash flow arithmetic.
- Directors use dividends to signal the strength of the company's position.
- Dividends either show no growth or constant growth.
- Other influences on share prices are ignored.
- The company's earnings will increase sufficiently to maintain dividend growth levels.
- The discount rate used exceeds the dividend growth rate.

Discounted cash flow basis of valuation:

DCF method of share valuation may be appropriate when one company intends to buy the assets of another company and to make further investments in order to improve cash flows in the future.

**Step 1** Estimate the cash flows that will be obtained each year from the acquired business.

**Step 2** Discount these cash flows at an appropriate cost of capital. This produces a value either for the equity shares or for the business as a whole.

## 在考试中需要对使用的方法进行comment

# **Market Efficiency Hypothesis**

Definition of market efficiency:

#### ✓ Allocative efficiency

If financial markets allow funds to be directed towards firms which make the most productive use of them, then there is allocative efficiency in these markets.

#### ✓ Operational efficiency

Financial markets have operational efficiency if transaction costs are kept as low as possible.

#### ✓ Informational processing efficiency

The information processing efficiency of a stock market means the ability of a stock market to price stocks and shares fairly and quickly.

### Varying degrees of efficiency: U Weak form efficiency

If a stock market has weak form efficiency, it is not efficient at responding to events that affect companies and should affect share prices. It does not react to much of the information that is available about a company.

### □ Semi-strong form efficiency

If a stock market displays semi-strong efficiency, current share prices reflect both: 1) All relevant information about past price movements and their implications, and 2) All publicly-available knowledge about companies and market returns Share prices respond quickly to new information as it becomes

Share prices respond quickly to new information as it becomes available.

# **Market Efficiency Hypothesis**

### □ Strong form efficiency

If a stock market displays a strong form of efficiency, share prices reflect all information, whether it is publicly available or not:

- From past price changes
- From public knowledge or anticipation
- From specialists' or experts' insider knowledge

If a stock market has strong form efficiency, share prices will respond to new developments and events before they even become public knowledge. Features of efficient markets:

- ✓ The prices of securities bought and sold reflect all the relevant information available to the buyers and sellers, and share prices change quickly to reflect all new information about future prospects.
- ✓ No individual dominates the market.
- Transaction costs of buying and selling are not so high as to discourage trading significantly.
- ✓ Investors are rational and so make rational buying and selling decisions, and value shares in a rational way.
- $\checkmark$  There are low, or no, costs of acquiring information.

Impact of efficiency on share prices:

- If a company makes an investment with a positive net present value (NPV), shareholders will get to know about it and the market price of its shares will rise in anticipation of future dividend increases.
- ✓ If a company makes a bad investment, shareholders will find out and so the price of its shares will fall.
- ✓ If interest rates rise, shareholders will want a higher return from their investments, so market prices will fall.

The valuation of shares:

**Fundamental analysis** is based on the theory that share prices can be derived from a rational analysis of future dividends.

**Technical analysts** or chartists work on the basis that past price patterns will be repeated, therefore future price movements can be predicted from historical patterns of share price movements in the past, and there are some patterns that continually re-appear.

**Random walk theory** is based on the idea that share prices will alter when new information becomes available.

Share prices are also affected by marketability and liquidity of shares, availability and sources of information, market imperfections and pricing anomalies, market capitalization and investor speculation.

Which theory of share price behaviour does the following statement describe?

'The analysis of external and internal influences upon the operations of a company with a view to assisting in investment decisions.'

A Technical analysis B Random walk theory C Fundamental analysis theory D Chartism The following statements relate to the valuation of shares and market efficiency.

- 1 Technical analysis is based on the theory that share prices can be derived from an analysis of future dividends
- 2 Under the strong form hypothesis of market efficiency, share prices reflect all available information about past changes in the share price

Are the statements true or false?

- A Both statements are true
- B Both statements are false
- C Statement 1 is true and statement 2 is false
- D Statement 2 is true and statement 1 is false

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# Thank You!

