

Why People Disagree About What Drives Stock Prices*

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February 2026

Abstract

We show that, to a first-order approximation, estimates of fluctuations in Shiller's fundamental price relative to observed price depend primarily on forecasts of long-horizon expected returns. Researchers using different measures of cash flow and valuation may reach different conclusions about the extent to which values fluctuate excessively relative to fundamentals, but that is only because return forecasts based on different cash-flow-to-value measures will be different. Using U.S. equity data, we demonstrate that the amount of persistence in expected returns, rather than the amount of short-run return predictability, is the key determinant of implied excess volatility. Disagreements about stock market valuation therefore reduce to disagreements about long-run expected returns.

KEYWORDS: Cash flows, Excess Volatility, Long Run Returns, Trading Strategies

JEL CLASSIFICATION CODES: G12,G32,G35

*The views expressed herein are those of the authors and not necessarily those of the Federal Reserve Bank of Minneapolis or the Federal Reserve System. We would like to thank Stefan Nagel for a very helpful discussion of a previous draft of this paper and Charles Engel, Ellen McGrattan, Moto Yogo, Stavros Panageas, Yueran Ma, Andrea Eisfeldt, Stijn Van Nieuwerburgh, Zhengyang Jiang, Dan Greenwald, Sydney Ludvigson, and Martin Lettau for many helpful conversations on this topic.

1 Introduction

Shiller (1981) famously asked, “Do stock prices move too much to be justified by subsequent movements in dividends?” Since the work of Campbell and Shiller (1988a) and Campbell and Shiller (1988b), this question has been reframed as a question about what drives the dynamics of dividend-price ratios posed in the context of a first-order approximation to a present value identity. In this reframing, under the hypothesis that dividend-price ratios are stationary, their movements should be driven either by changes in expected future returns or by changes in expected future dividends.

Most analyses of this question of what drives movements in the dividend-price ratio for the aggregate stock market use data on price-per-share and dividends-per-share defined for broad stock indices. These analyses have argued that most of the volatility of the stock market is driven by movements in future expected returns. See Cochrane (2011), Campbell (2014), and Campbell (2018) for summaries of this argument. But others, using alternative measures of value and cash flows, have found a larger role for cash flows, with the paper by Larrain and Yogo (2008) being a prominent early example of such research.¹

Here, we aim to make a theoretical and an applied contribution to the question of what drives volatility in equity prices. Our theoretical point is that quantifying the extent to which stock prices are excessively volatile, as defined by Shiller (1981), requires directly quantifying the extent of time variation in future expected returns. Quantifying the predictability of cash flow growth for different cash flow measures does not help answer Shiller’s question. Our applied point is that valuations will primarily be driven by fluctuations in expected cash flows unless there is significant time variation in expected returns over very long horizons. These conclusions are, to a first-order approximation, independent of the choice of price and cash flows used in the analysis. Hence, we conclude that different researchers arrive at different conclusions about what drives the stock market because they have different forecasts of future long-horizon returns.

To understand these points, we first emphasize, as did Marsh and Merton (1986), that while there is a unique sequence of one-period total returns to investing in the aggregate equity market, this path for returns can be implemented by many possible paths for equity value and cash flow, each of which corresponds to a different way to split the same sequence of returns into a capital gain component and a cash flow component. For example, firms choose whether returns to their owners take the form of dividend income or equity-repurchase-generated capital gains; Miller and Modigliani (1961) show that this choice does not impact returns.

¹This is a large literature surveyed in Kojien and Van Nieuwerburgh (2011). Other examples include Baker and Wurgler (2000), Boudoukh et al. (2007), Chen (2009), Van Binsbergen and Kojien (2010), Bansal and Yaron (2011), Chen, Da, and Priestley (2012), Eaton and Paye (2017) and Pruitt (2025).

Similarly, investors can choose whether or not to adjust their cash flow from equity investment in response to initial public offerings (IPOs) or myriad other corporate actions that change total equity market capitalization. In fact, investors can choose from an infinite number of possible “trading strategies”, each of which corresponds to a different sequence for the amount of funds invested relative to aggregate market capitalization. Different trading strategies correspond to different sequences for equity value P_t , dividends D_t , and the dividend yield D_t/P_t . How does one’s answer to the question of what drives the stock market depend on the trading strategy used in constructing one’s data on price and cash flows?

To answer this question, following [Shiller \(1981\)](#), we define a *fundamental price*, P_t^* as equal to the present value of expected future dividends discounted at a constant rate. Our first result is that the ratio of this fundamental price to the observed price P_t^*/P_t is equivalent to a discounted sum of dollar-weighted deviations of expected returns from a constant benchmark divided by current price. Note that the trading strategy shows up in the ratio of fundamental price to observed price only through the dollar weights applied to future expected returns.

We next show that, to a first-order approximation, the dynamics of this ratio depend only on expected returns without consideration of their dollar weighting.² With this simplification, we see that, to a first-order approximation, the problem of estimating the dynamics of Shiller’s fundamental price relative to observed price comes down to estimating the dynamics of the familiar discounted sum of expected log returns from a Campbell-Shiller log-linear approximation. Hence, given the results of [Miller and Modigliani \(1961\)](#) that total returns are not altered by the choice of trading strategy, to a first-order, estimates of the dynamics of P_t^*/P_t should also not be impacted by the choice of trading strategy used to construct the data on value and cash flows.

How does this result on P_t^*/P_t relate to familiar Campbell-Shiller-style decompositions of D_t/P_t ? It is an identity that the ratio of cash flow to observed price, D_t/P_t , is equal to the ratio of fundamental price to observed price, P_t^*/P_t , times the ratio of cash flow to fundamental price, D_t/P_t^* , where the last term is the analogue to the expected dividend growth term in the standard Campbell Shiller decomposition. While different trading strategies imply different sequences for D_t/P_t , the results above indicate that they should imply the same sequence (up to the first-order approximation) for P_t^*/P_t . It follows that different trading strategies must imply different time paths for the expected dividend growth term D_t/P_t^* .

We conclude that quantifying whether fluctuations in cash flows account for a large or a small share of fluctuations in the price-dividend ratio under a particular trading strategy is not informative about what drives fluctuations in the price itself. Different trading strategies

²We see this as the fundamental simplification offered by the first order approximation commonly used in this literature — the hypothesis that the dollar weighting of returns can be safely ignored. [Dichev \(2007\)](#) argues otherwise.

will imply different decompositions for the dynamics of the price-dividend ratio, but those different strategies should imply the same path for expected returns – there is only one such path – and thus the same path for P_t^*/P_t . If researchers working with different cash flow measures end up estimating different paths for P_t^*/P_t , that must be because they are making different forecasts for expected returns. Thus, disagreements around what drives valuations can only be resolved by deciding which return forecasts are more reasonable and which are less reasonable.

These results lead to our third point: the question of the role of variation in expected returns in driving fluctuations in the ratio of fundamental price to observed price is really a question about the dynamics of expected returns over long horizons.³ To illustrate this point, we consider a simple model in which expected log returns (in excess of aggregate consumption growth) follow an AR(1) process. In this case, the dynamics of the log ratio of fundamental price to observed price are determined by two statistics. The first is a sequence of estimates of one-period ahead expected log returns, $\mathbb{E}_t r_{t+1}$. The second is the persistence of these expected returns.

We first show that one can obtain a remarkably high R^2 coefficient forecasting aggregate stock market returns one-year ahead with a cash flow to value ratio based on a broad measure of payouts to investors.⁴ But we also show that fluctuations in this return predictor based on aggregate cash flow are quite transitory, suggesting only transitory fluctuations in expected returns, and thus only small fluctuations in our estimate of $\log(P_t^*/P_t)$. These estimates thus imply that it is expected cash flows that are the dominant driver of movements in the value of the stock market.

Next, we contrast these results to those obtained following the same procedure, but using as our return-predictor the ratio of dividends per share to price per share. This ratio is a much poorer predictor of one-year ahead returns than the ratio using our broader cash flow measure. But this per share dividend yield measure is much more persistent, and as a result, implies much larger fluctuations in expected long run returns, and in our estimate for $\log(P_t^*/P_t)$.

Our results also have implications for estimates of the drivers of the stock market boom over the past 25 years. There is a very persistent downward shift in the ratio of dividends per share to price per share in the 1990s, which the model estimated using per-share data interprets as signaling persistently lower expected returns. However, the fact that this step down is not apparent in our broader dividend-price ratio series indicates that it reflects a trend break in the rate at which a per-share investor is reducing their equity ownership

³We see this as the central point of [Larrain and Yogo \(2008\)](#).

⁴See [Baker and Wurgler \(2000\)](#) and [Boudoukh et al. \(2007\)](#) and related papers.

relative to aggregate market capitalization. This break in turn mechanically reflects a mix of a fall in the rate of new firm entry to U.S. equity markets coupled with a rise in the rate of equity repurchases. We therefore advise caution in interpreting the observed step-down in the per share dividend-price ratio as reflecting a permanent decline in expected returns.

Our analysis is closely related to [Larrain and Yogo \(2008\)](#) and to recent discussions by [Nagel \(2024\)](#), but goes beyond both. [Larrain and Yogo \(2008\)](#) show empirically that broader payout measures shift Campbell–Shiller decompositions toward a larger role for cash-flow news. They and [Nagel \(2024\)](#) emphasize that conclusions about excess volatility depend critically on assumptions about the amount of variation in long-horizon expected returns. We provide a framework that connects and further illuminates these results. In particular, we (i) provide an exact expression for P_t^*/P_t that does not require a log-linear approximation, (ii) show that, to a first-order approximation, this ratio is invariant to cash flow measurement choices, (iii) clarify through our “trading strategy” framework how measurement choices impact cash-flow growth and cash-flow to value ratios, and (iv) illustrate precisely in an AR(1) framework how long-run return persistence matters more for the excess volatility question than short-run return predictability.

The remainder of the paper is organized as follows. In [Section 2](#) we define our measure of fundamental price and present our Proposition 1. In [Section 3](#) we develop our exact present value decomposition and relate the terms to those obtained from a first-order approximation to this relationship. In [Section 4](#) we illustrate the impact of the trading strategy on measures of value, cash flows, and ratios of cash flows to value. In [Section 5](#), we contrast measures of value and cash flows for two trading strategies: one corresponding to a per-share index investor, and an alternative for an investor who holds a constant share of the total market at each date. In [Section 6](#), we show how analysts studying the valuation and cash flow series associated with these two different trading strategies might come to very different conclusions about what drives the stock market.⁵

2 A Decomposition of Asset Price Movements

Consider data on the price of some asset $\{P_t\}$ and the cash flows paid to the owner of that asset $\{D_t\}$. These data provide us with sequences of realized returns with dividends R_{t+1}^{wd} and

⁵The Appendix offers a detailed proof of Proposition 1, a discussion of first-order approximations, a description of our data sources and construction, additional results of return forecasting regressions, and an extended discussion of the argument in [Cochrane \(2008\)](#) that most movements in the stock market are driven by movements in expected returns.

without dividends R_{t+1}^{nd} :

$$R_{t+1}^{wd} \equiv \frac{P_{t+1} + D_{t+1}}{P_t} \quad \text{and} \quad R_{t+1}^{nd} \equiv \frac{P_{t+1}}{P_t}.$$

We wish to make use of the framework laid out in [Shiller \(1981\)](#) to estimate the drivers of stock price volatility. To do so, we study the following identity decomposing the asset price P_t into two components:

$$P_t = P_t^* + \Phi_t, \tag{1}$$

where

$$P_t^* \equiv \sum_{k=1}^{\infty} \beta^k \mathbb{E}_t D_{t+k} \tag{2}$$

for some $\beta < 1$. In this decomposition, P_t^* is the expected present value of dividends discounted at a constant rate β . We label P_t^* the “fundamental” component of price.⁶ The component Φ_t is simply the difference between the observed price P_t and the fundamental component P_t^* . We label Φ_t the “residual” component of price.⁷

Our goal is to estimate the role of the fundamental price P_t^* in driving observed price P_t . In particular, we seek to estimate the dynamics of

$$\frac{P_t^*}{P_t} = \sum_{k=1}^{\infty} \beta^k \mathbb{E}_t \frac{D_{t+k}}{P_t}. \tag{3}$$

If this ratio is constant over time, then we must have that fluctuations in observed price are equal to fluctuations in fundamental price P_t^* . To the extent that this ratio P_t^*/P_t does vary over time, then fluctuations in observed price P_t differ from fluctuations in fundamental price, with this difference accounted for by fluctuations in the residual term Φ_t/P_t .

To implement this estimation, we make use of the following proposition.

⁶We will assume that β is small enough that the infinite sum in equation (2) is defined.

⁷How should this residual component be interpreted? Let $M_{t,t+k}$ denote the stochastic discount factor used to discount between periods t and $t+k$. The observed price P_t can then be expressed as

$$P_t = \sum_{k=1}^{\infty} \mathbb{E}_t M_{t,t+k} D_{t+k} + \Theta_t,$$

where the term Θ_t reflects all other influences on price other than the expected discounted present value of dividends. Given equations (1) and (2), the residual component of price is given by

$$\Phi_t = \sum_{k=1}^{\infty} \mathbb{E}_t [M_{t,t+k} - \beta^k] D_{t+k} + \Theta_t.$$

Thus, the residual component of price captures fluctuations in discounting done by $M_{t,t+k}$ relative to the constant rate β^k and all other influences on price as captured by Θ_t .

Proposition 1: The dynamics of the ratio of the fundamental price to observed price can be restated in terms of the dynamics of dollar-weighted expected returns as

$$\frac{P_t^*}{P_t} = 1 + \sum_{k=0}^{\infty} \beta^{k+1} \mathbb{E}_t \left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right] \frac{P_{t+k}}{P_t}. \quad (4)$$

Proof: Equation (4) follows from the observation that for all realizations of cash flows and returns

$$\frac{D_{t+k+1}}{P_t} = \left(\frac{R_{t+k+1}^{wd}}{R_{t+k+1}^{nd}} - 1 \right) \frac{P_{t+k+1}}{P_t}.$$

Applying this formula term-by-term to realizations of the right side of equation (3), adding and subtracting 1, and then taking conditional expectations gives the result. Details of these algebraic steps are in Appendix A.

3 Relationship to Campbell-Shiller Decompositions

Following [Campbell and Shiller \(1988a\)](#), there is a large literature in finance that examines the dynamics of dividend-price ratios D_t/P_t , expected returns, and changes in future cash flows using a first-order approximation to the joint dynamics of these series. Our decomposition of the dynamics of price in equation (4) relates to this literature as follows.

We can characterize the dynamics of the ratio of cash flows to price from the identity

$$\frac{D_t}{P_t} = \left(\frac{P_t^*}{P_t} \right) \left(\frac{D_t}{P_t^*} \right), \quad (5)$$

where P_t^*/P_t is given by equation (4) and

$$\frac{D_t}{P_t^*} = \left(\sum_{k=1}^{\infty} \beta^k \mathbb{E}_t \frac{D_{t+k}}{D_t} \right)^{-1}. \quad (6)$$

Equation (5) gives an exact decomposition of the dynamics of the dividend-price ratio into a component due to fluctuations in the ratio of fundamental price to observed price and a component due to expected growth of cash flows, where the latter is defined in equation (6).⁸ Taking logs of both sides of equation (5), we can see that the log-linear approximation made popular by [Campbell and Shiller \(1988a\)](#) and the many papers that follow is based on

⁸Note that equation (5) does not depend on the question of whether the dividend-price ratio is stationary. It only requires that the infinite sums considered converge.

the claim that

$$\log\left(\frac{P_t^*}{P_t}\right) \approx \sum_{k=0}^{\infty} \rho^k \mathbb{E}_t [r_{t+k+1}^{wd} - \bar{r}] \quad (7)$$

where $r_{t+1}^{wd} = \log(R_{t+1}^{wd})$ and ρ and \bar{r} are constants of approximation.⁹ Thus, to the extent that this first-order approximation in equation (7) is accurate, the dynamics of the log ratio of fundamental price to observed price is a function only of the dynamics of expected log returns without reference to the dollar-weighting of returns (other than through the choice of the constant ρ).¹⁰

This observation brings us to our main result. To the extent that the first-order approximation in equation (7) is accurate, different researchers using different measures of value and cash flows corresponding to different trading strategies arrive at different conclusions as to what drives the stock market in terms of estimates of the dynamics of P_t^*/P_t because these researchers are arriving at different conclusions about the dynamics of expected returns. All other considerations are second-order.

What do we know about the dynamics of expected returns? Unfortunately, there is considerable disagreement in the literature regarding the dynamics of expected returns, as discussed, for example, by [Goyal and Welch \(2008\)](#) and [Goyal, Welch, and Zafirov \(2023\)](#). [Boudoukh, Richardson, and Whitelaw \(2008\)](#) and others suggest that this disagreement is particularly severe for estimates of the volatility of long-horizon expected returns. Hence, there is considerable room for disagreement regarding the question of what drives the stock market.

4 Trading Strategies and Return Forecasting

Why are different researchers coming to different conclusions regarding the dynamics of expected returns? One important reason is that researchers are using different measures of cash flows and price and hence are forecasting returns using different sequences for the dividend-price ratio, D_t/P_t . We now discuss why the data on price $\{P_t\}$, cash flows $\{D_t\}$, and the ratio $\{D_t/P_t\}$ are not uniquely defined for a given asset or portfolio of assets. Instead, these measures are altered by what we refer to as the *trading strategy* which defines the amount invested at each date.

To see this point, consider the sequences of portfolio value (which we call price) and cash

⁹We provide a more detailed derivation of this first order approximation including a discussion of these constants of approximation in [Appendix B](#).

¹⁰We do not take a stand on whether this first order approximation is sufficiently accurate to be useful. In [Appendix E.1](#) we consider an example in which a firm returns cash to its investors entirely through share repurchases and we show that in this case, this approximation is not useful.

flow recorded for an investor who follows a trading strategy of holding a time-varying fraction $\{S_t\}$ of total market capitalization of an asset, with S_t denoting the investor's holdings at the end of period t after cash flows are received. We let $\{\bar{P}_t\}$ and $\{\bar{D}_t\}$ be the sequences for portfolio value and cash flow recorded for an investor who holds a constant fraction $S_t = 1$ of the total market capitalization of the asset, and we denote the corresponding sequences of value and cash flow for an investor following trading strategy $S = \{S_t\}$ by $\{P_t(S)\}$ and $\{D_t(S)\}$ with

$$P_t(S) = S_t \bar{P}_t \quad (8)$$

and

$$D_t(S) = S_{t-1} \bar{D}_t + (S_{t-1} - S_t) \bar{P}_t. \quad (9)$$

These equations indicate that the trading strategy changes the time paths for P_t and D_t . But the time path for realized (and expected) total returns is invariant to the trading strategy, since

$$R_{t+1}^{wd}(S) = \frac{P_{t+1}(S) + D_{t+1}(S)}{P_t(S)} = \frac{S_{t+1} \bar{P}_{t+1} + S_t \bar{D}_{t+1} + S_t \bar{P}_{t+1} - S_{t+1} \bar{P}_{t+1}}{S_t \bar{P}_t} = \frac{\bar{P}_{t+1} + \bar{D}_{t+1}}{\bar{P}_t}.$$

Note also that the trading strategy changes the dynamics of valuation ratios, such as the ratio of cash flow to price:

$$\frac{D_t(S)}{P_t(S)} = \frac{S_{t-1}}{S_t} \frac{\bar{D}_t}{\bar{P}_t} + \frac{S_{t-1} - S_t}{S_t}. \quad (10)$$

Because cash flow to price ratios are commonly used to forecast returns, it is important to understand how alternative trading strategies impact the time path for $D_t(S)/P_t(S)$.¹¹

To illustrate this point, suppose the asset in question is a diversified portfolio of all equities in the CRSP Value-Weighted Total Market Index, and consider two alternative trading strategies. The first, which we label the strategy for an ‘‘aggregate investor’’ corresponds to maintaining a constant fraction of the aggregate market capitalization of the stocks in the CRSP index at the start of each period. The data on the value and cash flows associated with this trading strategy are $\{\bar{P}_t\}$ and $\{\bar{D}_t\}$. [Dichev \(2007\)](#) describes a simple methodology to recover cash flow \bar{D}_t from the end of period $t - 1$ to the end of period t for an aggregate investor. That cash flow is the solution to

$$R_t^{wd} = \frac{TMC_t + \bar{D}_t}{TMC_{t-1}} \quad (11)$$

where $TMC_t = \bar{P}_t$ is the total market capitalization of the stocks in the index (which CRSP

¹¹See Appendix E for a simple numerical example.

reports) and R_t^{wd} is the with-dividend return on the CRSP portfolio – recall that the trading strategy does not impact realized returns.

The second trading strategy we consider corresponds to that of a passive index investor. We refer to this trading strategy as that of a “per-share investor.” The per-share investor holds a time-varying fraction $\{S_t\}$ of the total market capitalization of the CRSP index, where S_t is equal to the ratio of the level of this index to the total market capitalization of the stocks in the index at the end of period t .¹² The per-share investor’s ownership share S_t will change every day as a result of what are called “corporate actions.” *Price per share* $P_t(S)$ for the per-share investor is given by the level of the index, while corresponding *dividends per share* $D_t(S)$ are given by equation (9).

There are many different sorts of corporate actions that lead the level of the index to diverge from the total market capitalization of the stocks in the index, but two important examples are Initial Public Offerings (IPOs) and equity repurchases. Following an IPO, S_t for an index investor declines: if a newly public firm accounts for one percent of aggregate market capitalization, the index investor sees her share of aggregate market capitalization decline by one percent because the level of the index does not change with the IPO. Conversely, if firms in the index collectively repurchase one percent of publicly-held equity, the index investor sees her share of aggregate market capitalization S_t rise by one percent because, again, the level of the index does not change with this corporate action. In both cases, it is the divisor of the index that is revised.¹³

While the total returns on the index R_{t+1}^{wd} are the same at each date for the aggregate investor and the per-share investor, the dynamics for price P_t , cash flows D_t , and the ratio of cash flows to price D_t/P_t will all be different. In particular, letting $s_t = (S_t - S_{t-1})/S_t$ denote the growth rate for S_t , equation (10) can be written as

$$\frac{D_t(S)}{P_t(S)} - \frac{\bar{D}_t}{\bar{P}_t} = -s_t \left(1 + \frac{\bar{D}_t}{\bar{P}_t} \right). \quad (12)$$

Thus, the difference between the per-share and the aggregate dividend-price ratio is proportional to s_t . If the ownership share of the per-share investor is growing (falling), then the per-share dividend-price ratio will be smaller (larger) than the aggregate ratio.

We can also explore how the trading strategy impacts expected cash flow growth. The identity in equation (5) can be applied to both the per-share dividend-price ratio and the

¹²The inverse of this ratio $1/S_t$ is referred to as the *index divisor*.

¹³We discuss the details of index construction in greater detail in Appendix C.

aggregate one. Substituting the aggregate version into equation (12) gives

$$\frac{D_t(S)}{P_t(S)} = \frac{\bar{P}_t^*}{\bar{P}_t} \left(\frac{\bar{D}_t}{\bar{P}_t^*} - \frac{s_t \left(1 + \frac{\bar{D}_t}{\bar{P}_t}\right)}{\frac{\bar{P}_t^*}{\bar{P}_t}} \right). \quad (13)$$

But we have argued that, up to a first-order approximation, the ratio of fundamental to observed price is independent of the trading strategy, implying $\frac{P_t^*(S)}{P_t(S)} \approx \frac{\bar{P}_t^*}{\bar{P}_t}$. Applying this approximation, the term in parentheses on the right-hand side of equation (13) must be an alternative expression for the inverse of expected cash flow growth defined as in equation (6), i.e.,

$$\left(\sum_{k=1}^{\infty} \beta^k \mathbb{E}_t \frac{D_{t+k}(S)}{D_t(S)} \right)^{-1} \approx \left(\sum_{k=1}^{\infty} \beta^k \mathbb{E}_t \frac{\bar{D}_{t+k}}{\bar{D}_t} \right)^{-1} - \frac{s_t \left(1 + \frac{\bar{D}_t}{\bar{P}_t}\right)}{\frac{\bar{P}_t^*}{\bar{P}_t}}. \quad (14)$$

Note that when $s_t > 0$ (the per-share investor is increasing her ownership share) expected growth in dividends per share will exceed expected growth in aggregate cash flow. That is the natural counterpart to the previous point that when $s_t > 0$ the per-share dividend-price ratio is smaller than the aggregate one.

Much of the literature examining the dynamics of the stock market has used the data on price per share and dividends per share for a per-share investor. But others, including [Larrain and Yogo \(2008\)](#), have used broader measures of value and cash flows closer to \bar{P}_t and \bar{D}_t . And other researchers have considered intermediate cases, for example adjusting dividends to incorporate the impact of repurchases and other corporate actions of incumbent firms, but excluding the effects of firm entry and exit.

The first-order approximation in equation (7) indicates that impact of the choice of trading strategy on the ratio of fundamental price to observed price is not first-order. So why have researchers working with different data corresponding to different trading strategies come to different conclusions regarding the dynamics of P_t^*/P_t ? The answer is that different trading strategies imply different paths for the valuation ratio $D_t(S)/P_t(S)$, and when those valuation ratios are used to forecast returns, they imply different amounts of return predictability.

We expand on this point in the remainder of this paper using data on value and cash flows for an aggregate investor and for a per-share investor to illustrate the dramatic difference in return forecasts that one obtains with these alternative measures of the ratio of cash flows to value.

5 Data from Two Trading Strategies

We use data from the CRSP Value-Weighted Annual File on WRDS for all three exchanges (NYSE, Amex, and NASDAQ) from 1929-2024 to construct series for value and cash flow for a per-share and an aggregate investor. Specifically, we use three data series from this file: gross realized nominal returns including dividends over the course of the year, R_t^{wd} , gross realized nominal returns not including dividends over the course of the year, R_t^{nd} , and end of year nominal Total Market Capitalization, TMC_t . For the per-share investor, we use the returns series with and without dividends directly to construct our measures of price per share \tilde{P}_t and dividends per share \tilde{D}_t , as discussed in Section 4. For the aggregate investor, $\bar{P}_t = TMC_t$ and we use equation (11) to solve for total cash flow \bar{D}_t .¹⁴

We scale all of our series on price and cash flow by nominal aggregate Personal Consumption Expenditure (PCE) in each year. This scaling implies that our series for total returns and for cash flow growth are both net of growth in PCE.¹⁵

The differences in the evolution of total market capitalization \bar{P}_t and price per share \tilde{P}_t for the CRSP Total Market Value-Weighted Index are illustrated in Figure 1a. The two series co-move, but there is much more long term growth in the market capitalization series.

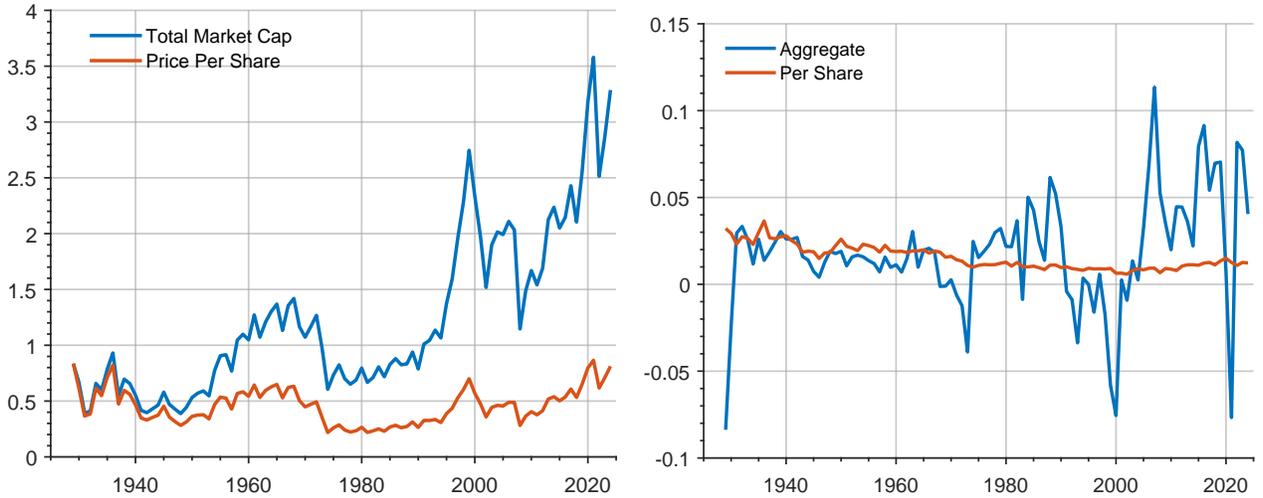
In Figure 1b, we show the ratio of \bar{D}_t/PCE_t for the aggregate investor in blue and the ratio of \tilde{D}_t/PCE_t for a per-share investor in red. We see that dividends per share are very smooth. In contrast, cash flow to an aggregate investor is quite volatile and often negative.¹⁶ Negative cash flow reflects net equity issuance, and is often associated with a wave of entry of firms into public markets.

From equations (8) and (9), we know that the differences in the dynamics of value and cash flows for the aggregate investor versus the index investor that are apparent in Figure 1 reflect the dynamics of the trading strategy for the index investor (the inverse of the index divisor). In Figure 2a, we show the log of the ratio of price per share to total market capitalization corresponding to the index investor trading strategy $\log(S_t)$. The dotted red lines are linear trendlines from 1929 through 1999 and from 2000 through 2024. One can see that from 1929 through 1999, $\log(S_t)$ declined steadily over time. The slope of the trendline in this figure from 1929 to 1999 is -2.02% . More recently, $\log(S_t)$ appears to level off, or even increase,

¹⁴We do scale total market capitalization after the addition of the Amex firms and then NASDAQ firms so that total market capitalization does not jump with the introduction of these exchanges to the data. Thus, for an aggregate investor, we are using a trading strategy that has $S_t = 1$ through the year that the Amex is introduced, then it jumps down to a lower level at which it remains until it jumps down again when the NASDAQ is introduced. Further details are provided in Appendix D

¹⁵One could alternatively scale by the price index for Personal Consumption Expenditure. If we did so, we would be looking to forecast real returns rather than real returns net of PCE growth.

¹⁶See also Davydiuk et al. (2023) for a similar calculation of aggregate cash flow to equity with similar results regarding the volatility of these cash flows.



(a) End-of-year total market capitalization relative to aggregate PCE (blue) and price per share relative to aggregate PCE (red). Price per share in 1929 is normalized to equal total market capitalization in that year.

(b) Total cash flows to an aggregate investor, \bar{D}_t , relative to aggregate PCE (blue) and dividends per share, \tilde{D}_t , relative to aggregate PCE (red).

Figure 1: Aggregate versus per-share valuation and cash-flow measures.

reflecting a combination of increased share repurchases by incumbent firms and a reduced rate of net entry of firms into public markets. The slope of the trendline in this figure from 2000 through 2024 is 2.6%.

In Figure 2b, we see that this change in trend in the per share trading strategy coincided with a significant change in trend growth in the log of dividends per share relative to PCE.

Figure 2c plots the dynamics of the ratio of cash flow to value for an aggregate investor, while Figure 2d shows the ratio of dividends per share to price per share. The dotted red lines in both of these figures show the means of these ratios over the period 1929-1999 and the period 2000-2024. We can see that the dynamics of these two cash flow to value ratios are quite different, at both high and low frequencies. The ratio of cash flow to value for an aggregate investor has large transitory fluctuations. But it appears fairly stable at long horizons. Its mean over the period 1929-1999 is 2.04%, compared to 1.83% over the period 2000-2024. In contrast, the ratio of price per share to dividends per share shows large changes at low frequencies. Its mean over the period 1929-1999 is 4.2%, while it is only 1.94% over the period 2000-2024. This stark difference between the low frequency dynamics of the cash flow to value ratio for an aggregate and an index investor reflects the two percentage points change in the trend growth rate of S_t shown in Figure 2a.¹⁷

¹⁷In Appendix F, we show that the trading strategy and cash flow to price ratios for an aggregate and a per-share investor in the S&P 500 show similar patterns.

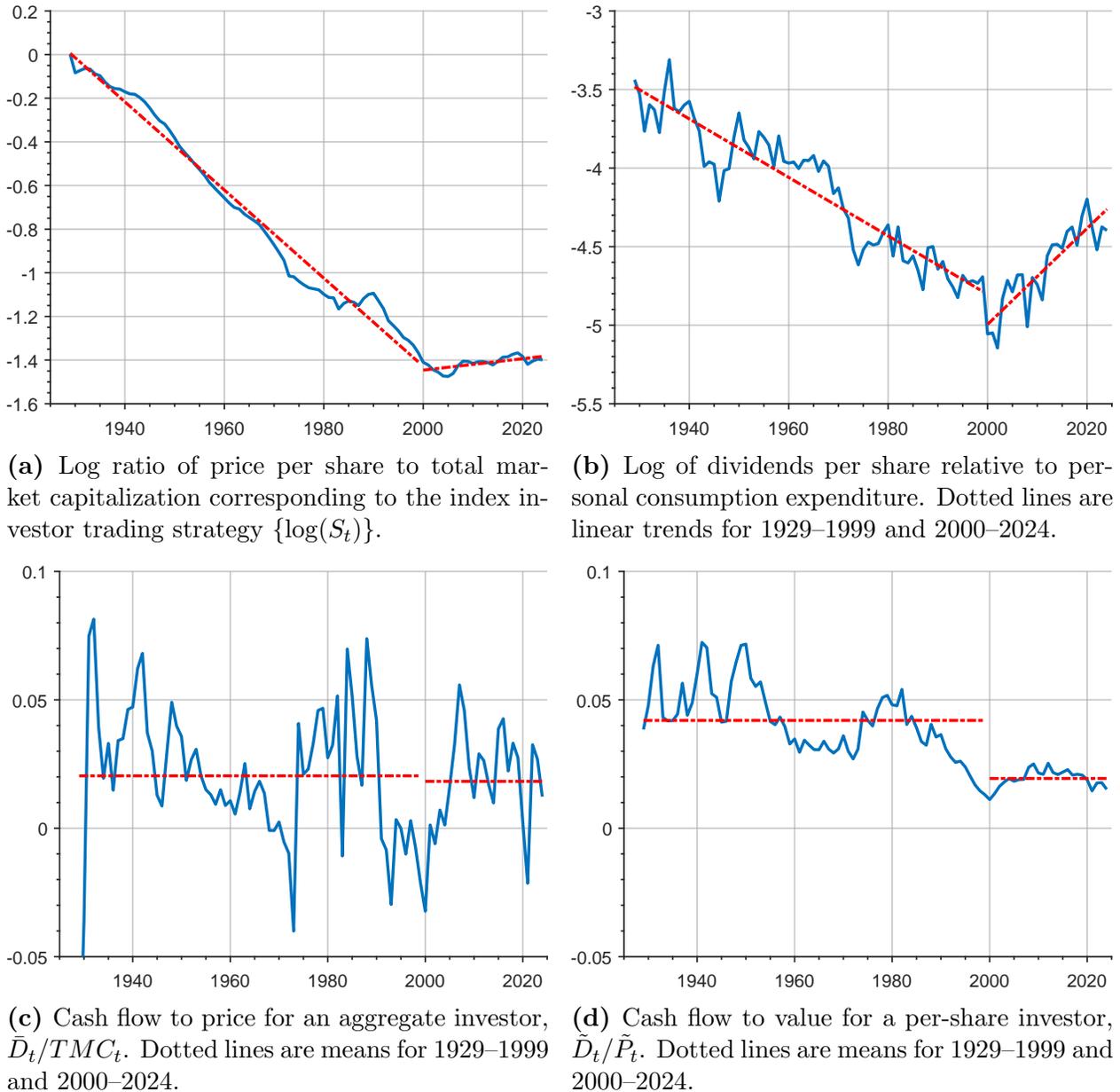


Figure 2: Trading strategies and cash-flow ratios.

To understand this, note that until 2000, new net equity issuance every year – by existing firms and via IPOs – was equal to about two percent of market capitalization. Given $s_t = -0.02$, equation (12) indicates that the per share dividend yield \tilde{D}_t/\tilde{P}_t was approximately two percent higher than the aggregate yield. The per share yield was boosted relative to the aggregate yield, because the per-share investor anticipated weaker cash flow growth, as her share of total market ownership was gradually diluted. Around 2000, net equity issuance dropped to near zero and remained there for the past 25 years, with equity issuance henceforth exactly offset by equity withdrawal via share repurchases. Equation (12) then accounts for

why the per share yield then fell by about two percent to converge to the aggregate yield.

6 Estimating P_t^*/P_t

Given the different dynamics of alternative measures of the ratio of cash flows to value shown in Figure 2, one should perhaps not be surprised to find different results about the forecastability of future returns depending on which of these two valuation ratios one uses to forecast.¹⁸ We now discuss how the different dynamics of these two valuation ratios lead to different conclusions regarding the dynamics of the ratio of fundamental price to observed price and hence different conclusions about what drives the stock market.

6.1 Our Estimation Approach

We take a simple approach to estimating the dynamics of the ratio of fundamental price to observed price in equation (7). We base our estimation on the observation that if one-period ahead expected returns $\mathbb{E}_t [r_{t+1}^{wd} - \bar{r}]$ follow an AR(1) process with persistence ψ , then equation (7) can be written

$$\log \left(\frac{P_t^*}{P_t} \right) \approx \frac{1}{1 - \rho\psi} \mathbb{E}_t [r_{t+1}^{wd} - \bar{r}]. \quad (15)$$

If equation (15) holds, then to estimate the dynamics of fundamental price to observed price, we need only estimate a series for one-period ahead expected log returns, $\mathbb{E}_t [r_{t+1}^{wd} - \bar{r}]$ and the persistence of those expected returns, ψ . We will set the constant of approximation ρ to 0.96 as is standard in the literature.

We next assume that investors use some measure of cash flow relative to value to forecast log returns in excess of PCE growth. We will compare and contrast forecasts based on two versions of that ratio corresponding to the two trading strategies we have discussed: the ratio for the aggregate investor, and the ratio for the per-share investor. The hypothesis that the ratio of cash flows to price for the aggregate investor is a good proxy for expected returns goes back to the findings of Baker and Wurgler (2000) and Boudoukh et al. (2007). Many others have used the per share version of the ratio to forecast returns.

¹⁸Lettau and Van Nieuwerburgh (2008) have also recognized that return forecasting becomes difficult if there are very persistent changes at certain dates in the ratio of dividends per share to price per share. They propose a statistical procedure to identify those break dates and to adjust forecasting regressions accordingly. Our approach of comparing aggregate and per share ratios and plotting an explicit path for $\{S_t\}$ allows for a simple visual identification of a break date, and strongly suggests that that break reflects a secular change in corporate payout policy rather than a permanent change in expected returns.

We therefore run two OLS forecasting regressions of the form

$$r_{t+1}^{wd} = \alpha_A + \gamma_A \frac{\bar{D}_t}{\bar{P}_t} + \epsilon_{A,t+1}, \quad (16)$$

$$r_{t+1}^{wd} = \alpha_P + \gamma_P \frac{\tilde{D}_t}{\tilde{P}_t} + \epsilon_{P,t+1}, \quad (17)$$

where r_{t+1}^{wd} denotes the log CRSP return net of growth in PCE between year t and year $t + 1$, and where we use the subscripts A and P to denote the coefficients for the aggregate and per share regressions. Results are reported in Table 1 with more details in Appendix H.

We use these two regressions to construct two alternative time series for $\log(P_t^*/P_t)$. In each case, we use the corresponding regression coefficient estimates to construct a time series for $\mathbb{E}_t[r_{t+1}^{wd} - \bar{r}]$. That series is then substituted into equation (15), where we set the persistence parameter ψ equal to the persistence of the aggregate or per-share dividend-price ratio, depending on the predictor being used.

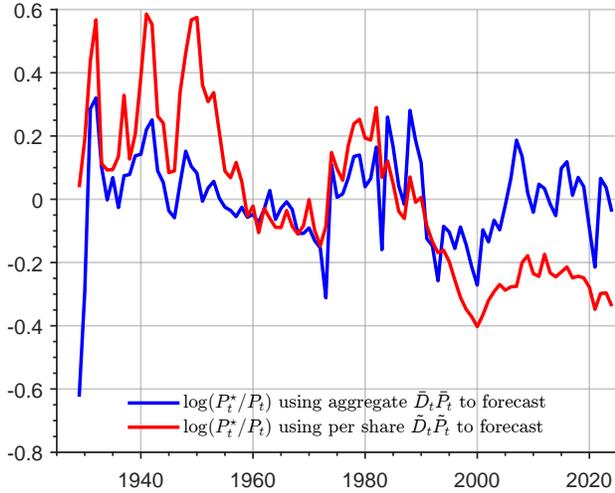
Given an estimated time series for $\log(P_t^*/P_t)$, we can immediately construct a corresponding time series for the aggregate fundamental price:

$$\log \bar{P}_t^* = \log(P_t^*/P_t) + \log \bar{P}_t. \quad (18)$$

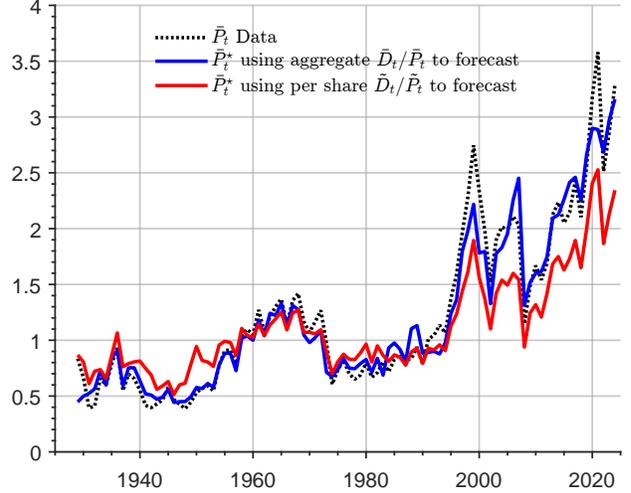
6.2 Our Estimation Results

The estimated series for $\log(P_t^*/P_t)$ from this procedure are shown in Figure 3a. Note that the two series are simply rescaled versions of the corresponding valuation ratios, D_t/P_t , where the scaling factor is equal to $\gamma/(1 - \rho\psi)$. The plot indicates more volatility in P_t^*/P_t when per share data is used to forecast returns. And that series indicates a step down in P_t^*/P_t in the 1990s, mirroring the step down in the \tilde{D}_t/\tilde{P}_t series visible in Figure 2d. Thus, the per share data points to a persistent decline in the present value of future expected returns in excess of PCE growth, and an associated decline in P_t^*/P_t of around 30 percent. Conversely, when the aggregate ratio is used to forecast returns, the implied ratio of P_t^*/P_t fluctuates around its historical mean in the post 2000 period, reflecting the fact that the aggregate valuation ratio \bar{D}_t/\bar{P}_t is also near its historical mean.

Figure 3b shows the ratio of aggregate market capitalization relative to PCE in black, against two estimated series for the corresponding fundamental price \bar{P}_t^* , where the blue series is constructed using the series for $\log(P_t^*/P_t)$ estimated from aggregate data, while the red series uses the series for $\log(P_t^*/P_t)$ estimated using per share data. In both cases, a large portion of observed fluctuations in valuations are attributed to time variation in the fundamental price. But a key distinction between the two models is apparent in recent



(a) Estimate of $\log(P_t^*/P_t)$ using D_t/P_t to forecast returns for an aggregate investor (blue) and a per-share investor (red).



(b) Total market capitalization (black) and estimated fundamental price for an aggregate investor (blue) and a per-share investor (red), all relative to personal consumption expenditure.

Figure 3: Estimated deviations from fundamental valuation.

decades. When the aggregate yield is used to forecast returns, almost the entire run-up in valuations since the 1980s is attributed to growth in the fundamental component of value. In contrast, when the per share yield is used a sizable gap opens up between observed valuations and the estimated fundamental component, where this gap reflects low expected returns going forward.

6.3 Why Different Trading Strategies Give Different Results

Why are the two paths in Figure 3 so different? First, the explanation for why the red series for $\log(P_t^*/P_t)$ is more volatile than the blue series is *not* that the per share dividend-price ratio generates more volatility in one-period-ahead expected log returns, $\mathbb{E}_t r_{t+1}^{wd}$. To the contrary, the per share ratio is a poor predictor of log returns one year ahead: the R^2 from regression (17) is only 0.03 (see Table 1). Rather, the high volatility reflects the fact that the per share dividend price series is very persistent, with an autocorrelation ψ of 0.903. Small movements in expected returns that are expected to be very persistent generate large deviations in equilibrium valuations relative to the expected present value of future cash flow.

When the aggregate dividend-price ratio is used to forecast returns, in contrast, the model is much more successful at forecasting near-term returns, consistent with prior findings in the literature. Regression (16) for predicting log one-year returns in excess of growth in PCE yields an $R^2 = 0.17$. The series for expected one year log returns has a standard deviation

Table 1: Valuation decompositions using alternative return predictors

	R^2	ψ	$\mathbb{V}ar\left(\log \frac{P_t^*}{P_t}\right)$	$\frac{\mathbb{V}ar(\log \bar{P}_t^*)}{\mathbb{V}ar(\log P_t)}$
Aggregate \bar{D}_t/\bar{P}_t	0.170	0.466	0.020	0.870
Per-share \tilde{D}_t/\tilde{P}_t	0.030	0.903	0.063	0.379
Per-share alternative	0.049	0.835	0.046	0.716

Column (1) reports R^2 from one-year-ahead log return forecasting regressions (equations 16 and 17). Column (2) reports the predictor autocorrelation ψ . Column (3) reports the variance of $\log(P_t^*/P_t)$. Column (4) reports the variance of the estimated log fundamental aggregate price relative to the variance of the observed aggregate log price, both measured relative to PCE.

of 7.9%, compared to 19.2% for realized log returns. But the aggregate dividend-price ratio \bar{D}_t/TMC_t is much less persistent than the per share version, with an autocorrelation ψ of only 0.466. Because movements in expected returns are expected to be relatively transitory in this specification, they do not generate large movements in valuations.

To better understand the role of persistence, note that the variance of $\log(P_t^*/P_t)$, can be expressed in terms of the R^2 of the regression as:

$$\mathbb{V}ar\left(\log \frac{P_t^*}{P_t}\right) = \left(\frac{1}{1 - \rho\psi}\right)^2 \times R^2 \times \mathbb{V}ar(r_{t+1}^{wd}). \quad (19)$$

This expression indicates that the implied variance of $\log(P_t^*/P_t)$ is much more sensitive to ψ than to the regression fit statistic. In particular, given $\rho = 0.96$, an increase in persistence ψ from 0.466 to 0.903 is equivalent to reducing the R^2 for the one period return forecast by a factor of 17.2! Simply put, large but transitory fluctuations in expected returns have a minimal impact on equilibrium valuations.

In Table 1 we report the variance of the log fundamental price relative to the variance of log observed market capitalization (the latter is equal to 0.326). One minus this ratio provides a simple measure of excess volatility in the sense of Shiller (1981).¹⁹ When the aggregate dividend-price ratio is used to forecast returns, fluctuations in the inferred fundamental price account for 87% of the observed variance of valuations. When the per share yield is used instead, the fundamental share declines to 38%. Again, the source of this finding is that the model estimated using per share data points to very persistent fluctuations in expected

¹⁹From equation (18), one can decompose the variance of the observed aggregate price relative to PCE as

$$\mathbb{V}ar(\log \bar{P}_t) = \mathbb{V}ar\left(\log \frac{P_t^*}{P_t}\right) + \mathbb{V}ar(\log \bar{P}_t^*) + 2\text{Cov}\left(\log \frac{P_t^*}{P_t}, \log \bar{P}_t^*\right).$$

Thus, observed price volatility can be attributed to time-varying expected returns, time variation in the fundamental valuation, and co-movement between those two sources of valuation movements. See Table H.2 in Appendix H for complete variance decompositions of our different models.

returns, which account for a large share of movements in valuations.

Why is the per share dividend-price ratio so much more persistent than the aggregate one? One reason is that firms deliberately smooth dividend payments. But another reason is that the trend break around 2000 in the path for the per-share investor's share of aggregate market capitalization translates into a very persistent level shift downward in the per share ratio, as discussed in Section 5. We now argue that this downward shift should probably not be interpreted as reflecting a downward shift in expected returns.

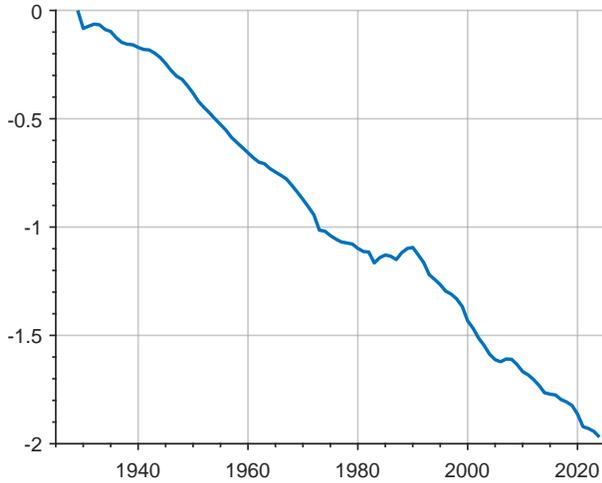
6.4 Have Expected Returns Declined?

We have shown that the persistent decline in the ratio of dividends per share to price per share in the 1990s coincides with a trend break in the rate at which the per-share investor's share of market ownership is diluted over time. Suppose this shift reflects an increase in the rate of share repurchases (a decline in the rate of equity issuance via existing firms or via IPOs would work similarly). Then one would expect a one-time decline in dividends per share, but faster growth in dividends per share moving forward. For example, if firms permanently raise the repurchase rate from zero to two percent of outstanding equity per year, price per share and dividends per share will grow two percent faster per year moving forward (see equations 8 and 9). Figure 2b illustrates precisely this sort of dynamic for dividends per share. We take that as a strong signal that one should interpret the downward shift observed in the series for dividends per share relative to price per share as reflecting a persistent change in the rate of net equity issuance and thus in the expected cash flow growth rate for a per share investor, rather than as a signal of lower expected returns.

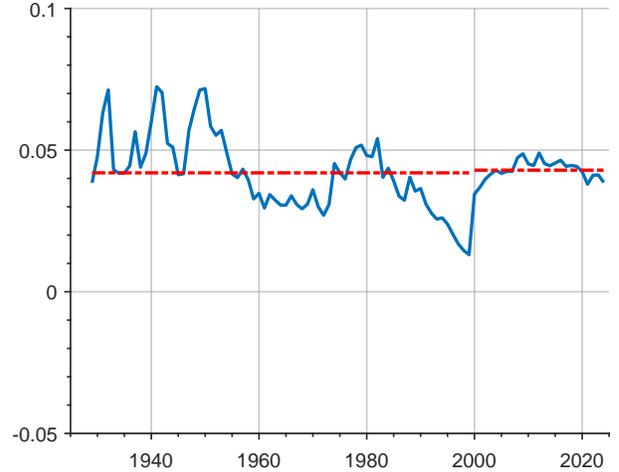
To further explore that hypothesis, we now consider yet another possible trading strategy. In particular, we construct time paths for D_t and P_t for a per-share investor who reduces the growth rate for S_t by a constant amount after 2000, so as to maintain the same downward trend in market ownership for the observed in Figure 2a for the pre-2000 period (see Appendix G for details). This adjustment removes the post-2000 break in ownership growth that mechanically depresses the per-share dividend yield.

Figure 4a illustrates this trading strategy, and Figure 4b shows the resulting alternative dividend-price ratio. The dotted red lines correspond to the mean of this alternative dividend-price ratio over the periods 1929-1999 and 2000-2024. This panel should be compared to Figure 2d. We see from this comparison that the dividend-price ratio constructed from this alternative trading strategy does not show the stark change in mean shown by the dividend-price ratio for a per-share investor. As a result, Figure 4d indicates that the model attributes almost all of the run-up in valuations in recent decades to higher expected future cash flows.

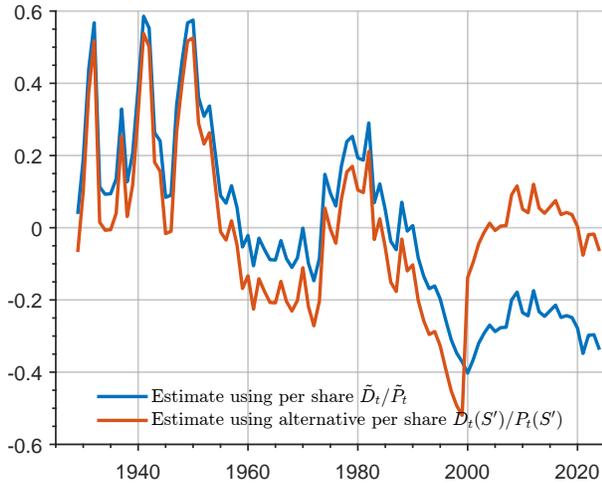
Table 1 indicates that the dividend-price series associated with this strategy is a better



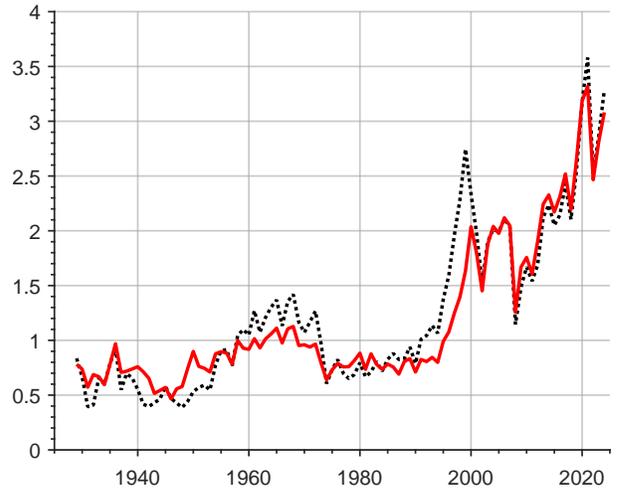
(a) Alternative trading strategy for a per-share investor, $\log(S')$.



(b) Dividend-price ratio under the alternative trading strategy. Dotted red lines show means for 1929–1999 and 2000–2024.



(c) Log ratio of fundamental to observed price estimated using per-share data and the alternative trading strategy.



(d) Total market capitalization relative to PCE (black) and estimated fundamental price relative to PCE (red) based on alternative strategy.

Figure 4: Alternative per-share trading strategy and implied valuation decomposition.

predictor of one-period returns than the original per share series. But it is also less persistent than that series, and thus it implies a smaller variance for $\log(P_t^*/P_t)$.

6.5 Relationship to **Cochrane (2008)**

Cochrane (2008) argued that dividend growth is hard to forecast, and thus that fluctuations in the dividend to price ratio should be interpreted entirely as reflecting time-varying expected returns. From taking logs of the terms in equation (5), under the Cochrane view,

fluctuations in the log of the ratio of dividends per share to price per share correspond entirely to fluctuations in the log ratio of fundamental price to observed price. But, as under the regression-based approach to forecasting described above, the implications of this view for the question of what drives the stock market hinge entirely on the path for the dividend-price ratio, which in turn depends on the trading strategy.

Using the original per share data, the Cochrane view suggests a rise in fundamental valuations of only around 50 percent between 1990 and 2024. In contrast, applying the Cochrane view to the alternative per share series attributes all of the surge in valuations over that period to the fundamental component (see Figure I.1 in Appendix I). Again, the reason is that under the alternative per share trading strategy, dividends per share in the post 2000 period are close to their historical average, implying that the fundamental price must be close to the observed one, and that expected future returns must be close to average. Thus, even under the Cochrane view that cash flow growth is unpredictable, the alternative per-share series suggests that the large boom in observed valuations almost entirely reflects a rise in the expected present value of future cash flows.

7 Conclusion

We have argued that if one wants to answer Shiller’s question of whether stock prices move too much to be justified by expected movements in cash flows, one must measure the extent to which the discounted value of dollar-weighted expected returns fluctuates relative to its unconditional mean. To a first-order approximation, this estimation problem can be simplified to ignore the effect of dollar-weighting of returns. Thus, to a first-order approximation, the estimate that one obtains for the dynamics of the ratio of fundamental price to observed price should not depend on the trading strategy used to define cash flows and price.

Our second point is more quantitative. We argued, in a simple model for estimation, that the determinants of the volatility of the ratio of fundamental price to observed price, P_t^*/P_t , are the volatility of expected returns one period ahead and the persistence of those expected returns, with the persistence being the more important of these two parameters. In particular, we argue that for movements in expected returns to generate significant movements in valuations, they must involve substantial movements in expected returns over long horizons.

It seems hard to resolve empirically the question of whether the returns net of growth that investors expect to receive over long horizons vary enough to be the primary driver of stock market fluctuations given the relatively short sample of volatile stock return data available to us.

In this paper, we have focused on alternative measures of dividend-price ratios as return

forecasting variables. There are, of course, other variables that one could use to forecast returns. Some have advocated for using corporate earnings as a cash flow measure. The fact that corporate earnings have declined relative to valuations in recent decades might then suggest that a significant portion of the observed run up in valuations reflects lower expected future returns. However, in [Atkeson, Heathcote, and Perri \(2026\)](#) we argue that a trend decline in labor's share of value-added coupled with relatively stable investment have translated into much faster growth in corporate free cash flow than in corporate earnings in recent decades, with the implication that the free cash flow yield has remained relative stable even as the earnings yield has declined.

Appendices

A Proof of Proposition 1:

The proof of Proposition 1 requires a number of algebraic steps.

First observe that

$$\frac{R_{t+k+1}^{wd}}{R_{t+k+1}^{nd}} - 1 = \frac{R_{t+k+1}^{wd} - R_{t+k+1}^{nd}}{R_{t+k+1}^{nd}} = \frac{D_{t+k+1}}{P_{t+k+1}}$$

This gives us that

$$\frac{D_{t+k+1}}{P_t} = \left(\frac{R_{t+k+1}^{wd}}{R_{t+k+1}^{nd}} - 1 \right) \frac{P_{t+k+1}}{P_t}$$

and thus

$$\begin{aligned} \sum_{k=0}^{\infty} \beta^{k+1} \frac{D_{t+k+1}}{P_t} &= \sum_{k=0}^{\infty} \beta^{k+1} \left(\frac{R_{t+k+1}^{wd}}{R_{t+k+1}^{nd}} - 1 \right) \frac{P_{t+k+1}}{P_t} = \\ &= \sum_{k=0}^{\infty} \beta^{k+1} \left(\frac{R_{t+k+1}^{wd}}{R_{t+k+1}^{nd}} \right) \frac{P_{t+k+1}}{P_t} - \sum_{k=0}^{\infty} \beta^{k+1} \frac{P_{t+k+1}}{P_t} = \\ &= 1 + \sum_{k=0}^{\infty} \beta^{k+1} R_{t+k+1}^{wd} \frac{P_{t+k}}{P_t} - \sum_{k=0}^{\infty} \beta^k \frac{P_{t+k}}{P_t} \end{aligned}$$

where we have added and subtracted one from the sum $\sum_{k=0}^{\infty} \beta^{k+1} \frac{P_{t+k+1}}{P_t}$. This gives us that

$$\sum_{k=0}^{\infty} \beta^{k+1} \frac{D_{t+k+1}}{P_t} = 1 + \sum_{k=0}^{\infty} \beta^{k+1} \left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right] \frac{P_{t+k}}{P_t}$$

Taking the conditional expectation of both sides of this equation gives us equation (4).

B First-Order Approximation

We can obtain the result that the ratio P_t^*/P_t , to a first order approximation, depends only on expected returns in two ways. One is with a linear approximation and another is with a log-linear approximation. We present both here.

We repeat equation (4)

$$\frac{P_t^*}{P_t} = 1 + \sum_{k=0}^{\infty} \beta^{k+1} \mathbb{E}_t \left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right] \frac{P_{t+k}}{P_t}$$

Note that the sum on the right side of this equation can be written

$$\sum_{k=0}^{\infty} \beta^{k+1} \mathbb{E}_t \left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right] \mathbb{E}_t \frac{P_{t+k}}{P_t} + \sum_{k=0}^{\infty} \beta^{k+1} \text{Cov}_t \left(\left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right], \frac{P_{t+k}}{P_t} \right)$$

We will assume that these covariance terms are constant over time

$$H = \sum_{k=0}^{\infty} \beta^{k+1} \text{Cov}_t \left(\left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right], \frac{P_{t+k}}{P_t} \right)$$

With this assumption we have that

$$\frac{P_t^*}{P_t} = 1 + H + \sum_{k=0}^{\infty} \beta^{k+1} Z_t^{(k)} G_{P,t}^{(k)} \quad (20)$$

where

$$Z_t^{(k)} \equiv \mathbb{E}_t \left[R_{t+k+1}^{wd} - \frac{1}{\beta} \right]$$

and

$$G_{P,t}^{(k)} \equiv \mathbb{E}_t \frac{P_{t+k}}{P_t}$$

If we take a first-order Taylor approximation to equation (20) around the vectors $Z_t^{(k)} = 0$ (corresponding to $\mathbb{E}_t R_{t+k+1}^{wd} = 1/\beta$) and $G_{P,t}^{(k)} = \bar{G}_P^k$, we get

$$\frac{P_t^*}{P_t} \approx 1 + H + \sum_{k=0}^{\infty} \beta^{k+1} \bar{G}_P^k Z_t^{(k)}$$

which we can write as

$$\frac{P_t^*}{P_t} \approx 1 + H + \beta \sum_{k=0}^{\infty} \rho^k Z_t^{(k)} = 1 + H + \sum_{k=0}^{\infty} \rho^k [\beta \mathbb{E}_t R_{t+k+1}^{wd} - 1] \quad (21)$$

where

$$\rho \equiv \beta \bar{G}_P$$

Note that equation (21) gives us the result that the dynamics of the ratio of fundamental price to observed price are determined, to a first-order, only by the deviations of expected returns from the benchmark value of $1/\beta$.

A natural choice for β would be the reciprocal of the unconditional expectation of returns with dividends $1/\mathbb{E}R_{t+1}^{wd}$. A natural choice for \bar{G}_P would be the unconditional expectation of returns without dividends $\mathbb{E}R_{t+1}^{nd}$. Hence, a natural choice for ρ would be the ratio in

population of expected returns without dividends $\mathbb{E}R_{t+1}^{nd}$ and with dividends $\mathbb{E}R_{t+1}^{wd}$. In a deterministic model, this would be the ratio

$$\rho = \frac{P_{t+1}}{P_{t+1} + D_{t+1}} = \frac{1}{1 + D/P}$$

Note that this choice of ρ would depend on the trading strategy considered as this central dividend-price ratio depends on the growth of $\{S_t\}$. In particular, we see in Figure 2 panels (c) and (d) that the sample mean cash flow to value ratio for an aggregate investor and a per share investor are considerably different. This is simply the flip side of the observation that the cumulative price appreciation shown in Figure 1a for these two trading strategies is considerably different. Hence, one might wish to choose a value of $\rho = 0.98$ for an aggregate investor and $\rho = 0.96$ for a per share investor. In this paper we choose a single value of $\rho = 0.96$ for all of our calculations simply to be consistent with this choice in the literature.

We now move to a log-linear approximation. Specifically, to obtain equation (7), we make further assumptions about second moments. If returns are lognormal with constant conditional variances, then we have

$$\mathbb{E}_t R_{t+k+1}^{wd} = \exp(\mathbb{E}_t r_{t+k+1}^{wd} + J^{(k)})$$

where $J^{(k)}$ is one half the conditional variance of log expected returns at horizon k . Further assume that $J^{(k)}$ is a constant equal to J . (This would be true if returns were independent over time. It is not if there is persistent predictability of returns). With these assumptions, we can write equation (21) as

$$\frac{P_t^*}{P_t} \approx 1 + H + \beta \sum_{k=0}^{\infty} \rho^k Z_t^{(k)} = 1 + H + \sum_{k=0}^{\infty} \rho^k \beta \exp(\bar{r} + J) \exp(\mathbb{E}_t r_{t+k+1}^{wd} - \bar{r})$$

A linear approximation to this equation around $\mathbb{E}_t r_{t+k+1}^{wd} = \bar{r}$ gives

$$\log\left(\frac{P_t^*}{P_t}\right) \approx \frac{1}{1+H} \sum_{k=0}^{\infty} \rho^k \beta \exp(\bar{r} + J) (\mathbb{E}_t r_{t+k+1}^{wd} - \bar{r})$$

We then obtain equation (7) under the assumptions that $H = 0$ and $\beta \exp(\bar{r} + J) = 1$.

C Index Construction

The documentation for the CRSP Index Methodology is at <https://www.crsp.org/indexes/crsp-market-indexes-methodology/>. Here we give a heuristic summary of Chapter 8 of

this methodology manual describing index maintenance.

To construct these indices, one chooses a universe of firms to be included in the index in period t . We can index these firms by subscript i and this set of firms by Ω_t . At the start of the accounting period we have a number of shares outstanding $s_{i,t}$ for each firm $i \in \Omega_t$ and an initial price $p_{i,t}^o$. On a daily basis, a security's start-of-day price is defined as the previous day's end-of-day price adjusted for all splits and non-ordinary distributions, such as special dividends, returns of capital, and spin-offs.

Given the start of day price and the number of shares outstanding at the start of the day, one can construct value weights $w_{i,t} = p_{i,t}^o s_{i,t} / \sum_{j \in \Omega_t} p_{j,t}^o s_{j,t}$ and compute index returns without and with dividends for the period t from

$$R_t^{nd} = \sum_{i \in \Omega_t} \frac{p_{i,t}}{p_{i,t}^o} w_{i,t} \quad \text{and} \quad R_t^{wd} = \sum_{i \in \Omega_t} \frac{p_{i,t} + d_{i,t}}{p_{i,t}^o} w_{i,t}$$

where $p_{i,t}$ is the price of share i at the end of period t and $d_{i,t}$ are regular dividends paid by firm i during the period. The level of the index is referred to as the *price per share*, which we denote by \tilde{P}_t . The change in the level of the index from $t - 1$ to t is given by $\tilde{P}_t = R_t^{nd} \tilde{P}_{t-1}$. The *dividends per share* paid on the index in period t , which we denote by \tilde{D}_t , is the solution to $R_t^{wd} = R_t^{nd} + \tilde{D}_t / \tilde{P}_{t-1}$.

The entity constructing the index then follows a preset methodology to adjust the start of period t prices $p_{i,t}^o$ relative to end of period $t - 1$ prices $p_{i,t-1}$ as well as the number of shares outstanding for each firm in the index to adjust for corporate actions. These include special dividends, share repurchases, mergers, and the entry and exit of firms from the index. As discussed above, however, since the growth of the index from the end of $t - 1$ to the end of t is determined by R_t^{nd} for the index, the level of price per share does not change between the end of period $t - 1$ and the beginning of period t as a result of these corporate actions. However, the total market capitalization of the shares in the index does change from the end of period $t - 1$ to the beginning of period t as a result of these corporate actions. It changes from $TMC_{t-1} = \sum_{j \in \Omega_{t-1}} p_{j,t-1} s_{j,t-1}$ to $TMC_t^o = \sum_{j \in \Omega_t} p_{j,t}^o s_{j,t}$. Total market capitalization at the end of period t is then given by $TMC_t = R_t^{nd} TMC_t^o$. Thus, the ratio of the index to total market capitalization of the shares in the index at the end of period $t - 1$, which we denote by S_{t-1} , differs from this same ratio S_t at the end of period t because total market capitalization incorporates the effects of corporate actions while the index level does not.

D Data Sources and Construction

We take the data on nominal aggregate Personal Consumption Expenditure from NIPA Table 2.3.5.

We work with three sets of three time series from the CRSP annual data files for the Value-Weighted Index. These three series are total returns with dividends, $R_{j,t}^{wd}$, total returns without dividends, $R_{j,t}^{nd}$, and total market capitalization of the stocks in the index, $TMC_{j,t}$. We take these series for $j = 1$ corresponding to the CRSP file for the NYSE, $j = 2$ corresponding to the CRSP file for the NYSE and Amex, and $j = 3$ corresponding to the CRSP file for the NYSE, Amex, and NASDAQ.

We construct the series for R_t^{wd} , R_t^{nd} , and TMC_t that we work with as follows. We use the series for returns R_t^{wd} and R_t^{nd} from the NYSE file ($j = 1$) through 1962, from the NYSE and Amex file ($j = 2$) for 1963 through 1972, and from the NYSE, Amex, and NASDAQ file ($j = 3$) from 1973 through 2024.

We construct our series for TMC_t as follows. We take the series $TMC = TMC_{1,t}$ from the NYSE file ($j = 1$) for years through 1962. We define $\kappa_1 = \frac{TMC_{1,1962}}{TMC_{2,1962}}$ corresponding to the ratio of the total market capitalization of the stocks in the NYSE file at the end of 1962 to the total market capitalization of the stocks in the NYSE and Amex file for that year. We then set our measure of total market capitalization for 1963 through 1972 equal to $TMC_t = \kappa_1 TMC_{2,t}$. This adjustment is analogous to an adjustment of an index divisor so that our measure of total market capitalization does not jump due to the addition of the stocks listed on Amex during 1962. Likewise, we define $\kappa_2 = \frac{TMC_{2,1972}}{TMC_{3,1972}}$ corresponding to the ratio of the total market capitalization of the stocks in the NYSE and Amex file at the end of 1972 to the total market capitalization of the stocks in the NYSE, Amex, and NASDAQ file for that year. We then define our measure of total market capitalization as $TMC_t = \kappa_1 \kappa_2 TMC_{3,t}$ for 1973 through 2024.

We construct the measure of price per share that we use by setting $\tilde{P}_{1929} = TMC_{1929}$ and then we use for $t > 1929$, $\tilde{P}_t = R_t^{nd} \tilde{P}_{t-1}$. We construct the corresponding ratio of dividends per share to price per share from

$$\frac{\tilde{D}_t}{\tilde{P}_t} = \frac{R_t^{wd} - R_t^{nd}}{R_t^{nd}}. \quad (22)$$

We then construct our index of dividends per share from the product of \tilde{P}_t and this dividend-price ratio. Our measure of the variable S_t representing the trading strategy of an index investor is simply

$$S_t = \frac{\tilde{P}_t}{TMC_t},$$

which corresponds to the reciprocal of the index divisor.

We construct our measure of total cash flows to an aggregate investor from the solution for \bar{D}_t in the equation

$$\frac{TMC_t + \bar{D}_t}{TMC_{t-1}} = R_t^{wd}. \quad (23)$$

E Illustrative Examples: Alternative Trading Strategies

This numerical example illustrates how two investors can earn identical one-period returns while having different cash flows and dividend-price ratios.

Suppose there is a firm with N_t shares outstanding at the end of period t . Let P_t denote price per share, and let $\bar{P}_t = P_t N_t$ denote the firm's end of period market capitalization.

Firm-Level Accounting. Suppose that at the end of period t :

$$\begin{aligned} \bar{P}_t &= 100, \\ N_t &= 1, \\ \Rightarrow P_t &= 100. \end{aligned}$$

Suppose that in period $t + 1$, the total firm free cash flow is

$$\bar{D}_{t+1} = 20,$$

split between dividends and share repurchases:

$$\begin{aligned} D_{t+1} &= 10, \\ (N_t - N_{t+1})P_{t+1} &= 10. \end{aligned}$$

Suppose that at the end of $t + 1$ market cap is

$$\bar{P}_{t+1} = P_{t+1} N_{t+1} = 130$$

So we must have:

$$\begin{aligned} P_{t+1} &= (N_t - N_{t+1})P_{t+1} + P_{t+1}N_{t+1} = 140, \\ N_{t+1} &= \frac{P_{t+1}N_{t+1}}{P_{t+1}} = \frac{130}{140}. \end{aligned}$$

Trading Strategies. Define S_t as the investor's share of market ownership at the end of period t .

- Aggregate investor: $S_t = 1$ for all t .
- Per-share investor: holds one share, so

$$S_t = \frac{1}{N_t}.$$

Investor Outcomes. Aggregate investor:

$$\text{Price at } t : \bar{P}_t = 100,$$

$$\text{Cash flow at } t + 1 : \bar{D}_{t+1} = 20,$$

$$\text{Price at } t + 1 : \bar{P}_{t+1} = 130,$$

$$\text{Return : } \frac{\bar{P}_{t+1} + \bar{D}_{t+1}}{\bar{P}_t} = \frac{130 + 20}{100} = 1.5,$$

$$\text{Dividend yield : } \frac{\bar{D}_{t+1}}{\bar{P}_{t+1}} = \frac{20}{130}.$$

Per-share investor:

$$\text{Price at } t : P_t = 100,$$

$$\text{Cash flow at } t + 1 : D_{t+1} = 10,$$

$$\text{Price at } t + 1 : P_{t+1} = 140,$$

$$\text{Return : } \frac{P_{t+1} + D_{t+1}}{P_t} = \frac{140 + 10}{100} = 1.5,$$

$$\text{Dividend yield : } \frac{D_{t+1}}{P_{t+1}} = \frac{10}{140}.$$

Key Implication. Both investors earn identical one-period returns, but their dividend-price ratios differ:

$$\frac{\bar{D}_{t+1}}{\bar{P}_{t+1}} \neq \frac{D_{t+1}}{P_{t+1}}.$$

This example illustrates that total returns are invariant to the trading strategy, while dividend-price ratios depend mechanically on how payouts are split between dividends and repurchases.

Note also that equations (9) and (10) are satisfied. In particular, at $t + 1$

$$\begin{aligned} D_{t+1} &= S_t \bar{D}_{t+1} + (S_t - S_{t+1}) \bar{P}_{t+1} \\ 10 &= 20 + \left(1 - \frac{140}{130}\right) 130. \end{aligned}$$

E.1 A firm that does not pay dividends

We now explore the applicability of Proposition 1 and the first-order approximation (7) for a firm that does not pay dividends and instead returns cash to investors by changing the number of shares outstanding.

In particular, consider a firm that generates free cash flow $\{\bar{D}_t\}$ with value $\{\bar{P}_t\}$ given by

$$\bar{P}_t = \sum_{k=1}^{\infty} \mathbb{E}_t M_{t,t+k} \bar{D}_{t+k}$$

where $M_{t,t+k}$ is the stochastic discount factor between t and $t + k$.

Assume that $\bar{D}_t/\bar{P}_t > -1$ for all t . That assumes that the firm does not have negative free cash flow in any period in excess of its subsequent value.

Now assume that this firm starts with $N_0 = 1$ shares outstanding and it follows a policy of share issuance $\{N_t\}$ for $t \geq 1$ aimed at allowing it to pay no dividends and instead return all cash to its equity holders through net share repurchases. Define $S_t = 1/N_t$. We can solve from this trading strategy recursively from equation (9) as follows. Given $N_{t-1} = 1/S_{t-1}$, solve for S_t from equation (9) to set $D_t(S) = 0$. This solution is given by

$$S_t = S_{t-1} \left(\frac{\bar{D}_t}{\bar{P}_t} + 1 \right)$$

Note that our assumption above ensures that $S_t > 0$. Shares outstanding at the end of period t are then $N_t = 1/S_t$.

It is clear that, by construction, the fundamental value of a share of this firm is given by $P_t^*(S) = 0$ regardless of rates of return and free cash flows \bar{D}_t . The price appreciation per share is given by

$$\frac{P_{t+1}(S)}{P_t(S)} = R_{t+1}^{nd} = R_{t+1}^{wd}$$

One can verify that equation 3 holds with $P_t^* = 0$. To see this point, review the steps of the proof of Proposition 1 in Appendix A. Given that $R_t^{wd} = R_t^{nd}$ for all realizations, the term $D_t(S)/P_t(S) = 0$ for all realizations. The remaining steps of the proof then carry through.

This example shows that there are trading strategies for which the approximation (7) is not sufficiently accurate to be useful.

F Aggregate and Per Share Data for the S&P 500

The issues with the impact of trading strategies on measures of cash flows and price discussed in Section 5 and Figure 2 are pervasive to the construction of value-weighted stock market indices. To illustrate this point, we show the per-share trading strategy and alternative measures of the dividend-price ratio for an aggregate and per share investor constructed using data for the S&P 500 Index. The S&P 500 Index is a value-weighted index of approximately 500 stocks that was launched in its modern form in March of 1957.

Monthly data on measures of returns with dividends R_t^{wd} , returns without dividends R_t^{nd} , and total market capitalization of the stocks in the index TMC_t is available in the CRSP data on WRDS. We download monthly data on these three series starting in April of 1957 through the end of 2024. We construct a measure of the level of the S&P 500 Index by setting it equal to total market capitalization in April of 1957. We construct the level of the index (price per share) for subsequent months using the formula $\tilde{P}_t = R_t^{nd} \tilde{P}_{t-1}$. We then construct the implied monthly trading strategy $\{S_t\}$ using the formula $S_t = \tilde{P}_t / TMC_t$.

One can use these data to construct monthly data on price and cash flows using the formulas (22) and (23), but the resulting series for cash flows from these monthly data are extremely volatile for both a per-share and an aggregate investor, likely because of a large seasonal component in corporate payouts. (This is the case as well if we use monthly data for the CRSP Total Value Weighted Index). To deal with this issue, we construct measures of the ratio of cash flows over the course of 12 months to current value as follows.

We construct our measure of total returns over a 12 month period by compounding monthly returns with dividends R_t^{wd} . This gives us a series for total returns over 12 months (for an investor who reinvests dividends received during the year in the index itself) that we denote by $R_{t,12}^{wd}$. We assume that this measure of total returns applies to both an aggregate and a per-share investor. We construct our measure of returns without dividends for a per share investor by compounding monthly returns without dividends, which is equivalent to $R_{t,12}^{nd} = \tilde{P}_t / \tilde{P}_{t-12}$. We construct our measure of returns without dividends over 12 months for an aggregate investor as TMC_t / TMC_{t-12} . We then use these 12 month measures of returns with and without dividends to construct our measures of the ratios of cash flows to price using equation (22) for both a per-share and an aggregate investor.

We show results from this exercise in Figure F.1. In the left panel of this figure, we show monthly data on the log of the per share trading strategy $\log S_t$ for the S&P 500 Index

constructed as above. We see in this panel that the index grew more slowly than the total market capitalization of the stocks in the index (so that $\log(S_t)$ is declining) until the early 2000s. After that, we see that $\log(S_t)$ slightly increases over time. This changing trend growth in $\log(S_t)$ is similar to that for the CRSP Total Value Index. In the time period prior to 2000, $\log(S_t)$ declines at about 2 percent per year. Later, it appears to be flat or slightly rising. (Note that the S&P 500 does not have IPOs, but it does have firms that enter the index and firms that leave the index. A decline in S_t results when the firms that enter the index are larger in terms of their market cap than the firms that are removed from the index).

In the middle panel of Figure F.1 we show our measures of 12-month cash to price for an aggregate and a per-share investor in the S&P 500. The dividend-price ratio for an aggregate investor is in blue. The ratio for a per share investor is in red. We see in this figure that the ratio of cash flows to price for an aggregate investor is volatile but does not show a trend over time. In contrast, the ratio of cash flow to price for a per share investor drops by about 2 percentage points from the early decades of the sample to the last two decades of the sample – from around 4% to under 2%. Again, these differences in the low frequency movements in the ratio of cash flow to price for an aggregate and per share investor are simply due to the change in trend in the per share trading strategy shown in the left panel of this figure.

In the right panel of Figure F.1, we show the ratio of the log of our measure of 12-month cash flows relative to aggregate PCE. As we saw for the CRSP Index in Figure 2, the change in the trend of the trading strategy for the S&P 500 per-share investor shown in the left panel of Figure F.1 mechanically generates a change in trend growth of dividends relative to PCE. This observation is again consistent with the hypothesis that the step down in the ratio of dividends per share to price per share around 2000 shown as the red line in the center panel of Figure F.1 is an artifact of the changing trend in the trading strategy, resulting in a changing trend growth of dividends per share, and not a long-term change in expected returns net of growth.

G Alternative Per-Share Investor Trading Strategy

We construct our alternative series for trading strategy $\{S'_t\}$ for a per-share investor as follows. For dates $t = 1930$ through 1999 we set $S'_t = S_t$. For dates $t = 2000$ through 2024, we set

$$S'_t = \exp(-(t - 1999) \times 0.0228) S_t.$$

The coefficient 0.0228 is the difference between the slopes of the two segments of the dotted red trend line for $\log(S_t)$ plotted in the left panel of Figure 2 ($0.0026 - (-0.0202)$).

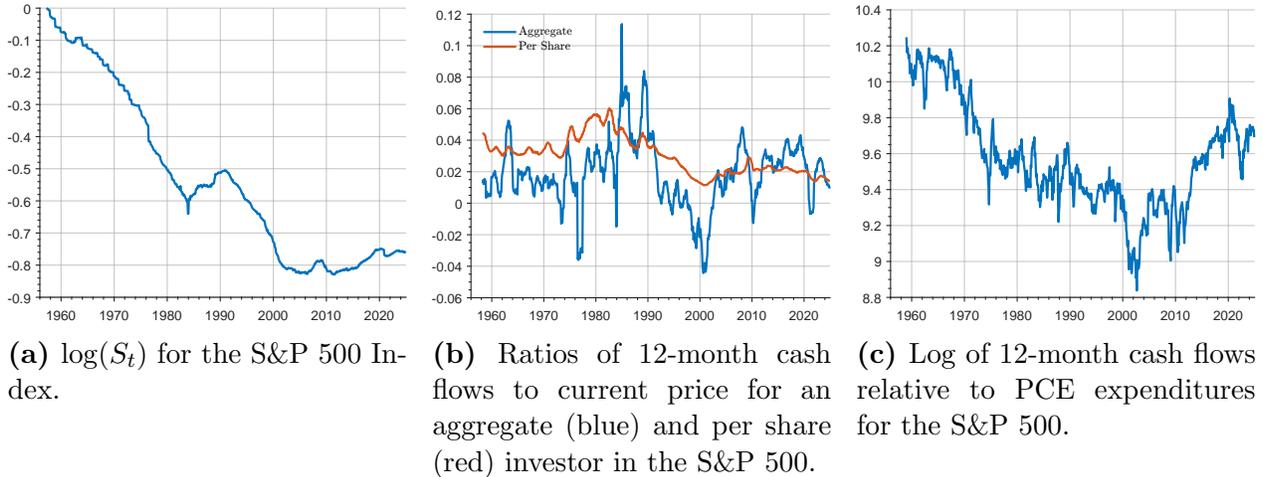


Figure F.1: Per Share Trading Strategy and Cash Flow to Value Ratios for the S&P 500.

With this construction, S'_t has the same downward trend in both sub-periods. We show this alternative trading strategy in Figure 4a. This panel should be compared to Figure 2a.

To construct the corresponding alternative values of price per share $P_t(S')$, dividends per share $D_t(S')$, and the ratio of dividends per share, we use equations (8), (9), and (10) with our data on value and cash flow for an aggregate investor and our alternative series for the trading strategy $\{S'_t\}$.

H Return Forecasts with Aggregate and Per Share Data

In this Appendix we report results from our return forecasting regressions. Note that, with an infinitely long sample of data one could evaluate equation (7) directly, by running direct return forecasting regressions at all horizons. In a finite sample, however, it is necessary to impose some structure on the path for expected returns. In what follows we evaluate our AR(1) assumption by comparing the predicted time paths for 10 year returns in excess of PCE growth implied by our AR(1) model against alternative forecasts from directly forecasting 10 year returns using the current dividend to price ratio. We find that the two sets of forecasts track each other very closely.

We report results from OLS return forecasting regressions of the form

$$r_{t+1}^{wd} = \alpha_1 + \gamma_1 Z_t + error_{t+1}$$

and

$$\frac{1}{10} \sum_{k=1}^{10} r_{t+k}^{wd} = \alpha_{10} + \gamma_{10} Z_t + error_{t+10},$$

Table H.1: Return forecasting regressions using alternative valuation ratios

Forecasting Variable Z_t	Horizon	R^2	$\hat{\gamma}$	t-stat	ψ	$Var(\log(P_t^*/P_t))$
Aggregate \bar{D}_t/\bar{P}_t	1 year	0.170	2.880	4.360	0.466	0.020
	10 years	0.179	0.690	4.250		
Per-share \tilde{D}_t/\tilde{P}_t	1 year	0.030	2.140	1.700	0.903	0.063
	10 years	0.153	1.190	3.870		
Alternative $D_t(S')/P_t(S')$	1 year	0.049	3.530	2.190	0.835	0.046
	10 years	0.294	1.970	5.880		

The dependent variable is log CRSP return net of PCE growth. The one-year horizon reports one-year-ahead returns. The ten-year horizon reports annualized log returns over the subsequent ten years.

where Z_t are alternative return forecasting variables. The first regression estimates expected log returns net of PCE growth one year ahead. The second regression estimates annualized expected log returns net of PCE growth over the next ten years.

We use three versions of Z_t to forecast log returns net of PCE growth one and ten years ahead. These are: (i) the ratio of cash flows to value for an aggregate investor $\frac{\bar{D}_t}{\bar{P}_t}$, (ii) the ratio of dividends per share to price per share $\frac{\tilde{D}_t}{\tilde{P}_t}$, and (iii) our alternative measure of the dividend-price ratio for a per-share investor $D_t(S')/P_t(S')$ constructed as described in Section D.

Further results for these regressions are reported in Table H.1. We see in this table that the ratio of cash flows to value for an aggregate investor has strong predictive power for log returns net of PCE growth one year ahead, but the R^2 of this regression does not grow at the ten-year horizon. In contrast, both of our other measures of cash flow to value have low predictive power for log returns net of PCE growth, but the R^2 of these regressions grows considerably at the ten year horizon. We appear to find significant predictability of returns net of PCE growth over a ten year horizon using all three of these return forecasting variables. The dividend-price ratio for a per-share investor constructed with our alternative trading strategy $D_t(S')/P_t(S')$ appears to be the best predictor of returns over a 10 year horizon.

We now use equation (15) to compute series for fundamental price relative to observed price implied by these regressions. To do so, we use estimates of ψ given by the autocorrelation of these three return forecasting variables. These give us an estimate of $\psi = 0.4658$ when using the cash flow to value ratio for an aggregate investor, $\psi = 0.9035$ when using the ratio for a per-share investor, and $\psi = 0.8353$ when using the alternative ratio of cash flow to value for a per-share investor that we constructed in Section D.

We report the implied variance of $\log(P_t^*/P_t)$ computed from these three estimates of

expected returns one year ahead in Table H.1. We see that, despite the high R^2 of the one year return forecasting regression using the ratio of cash flows to value for an aggregate investor \bar{D}_t/\bar{P}_t , our estimate of the variance of the log ratio of fundamental price to observed price is the smallest of the three estimates. This result follows from the low persistence ψ of this valuation ratio when we apply equation (15). In contrast, the ratio of dividends per share to price per share for a per-share investor \tilde{D}_t/\tilde{P}_t is a poor predictor of log returns net of PCE growth one year ahead, but, because it is very persistent, it results in the highest estimate of the variance of the log ratio of fundamental price to observed price. Note that that is true even though the alternative per share measure is a better predictor of 10 year returns.

Figure H.1 plots expected log returns net of PCE growth when these expected returns are based on regressions using the three different measures of cash flow to value described above. The top row of figures shows expected returns at a one year horizon, while the bottom row reports returns at a 10 year horizon. The forecasts based on per share measures indicate much more modest variability in one year expected returns, but much more volatility in expected returns over a 10 year horizon. Only the forecasts based on the original per share measure indicate a significant downward shift in long run expected returns in recent decades.

We can also examine the regression-implied time series estimates for the log ratio of fundamental price to observed price and for the level of P_t^*/PCE_t . We have shown results using the first two measures of the ratio of cash flows to value in Figure 3. We show results using our alternative dividend-price ratio in Figure 4.

In the left panel of this figure, we show the estimate of $\log(P_t^*/P_t)$ derived from the dividend-price ratio of a per-share investor in blue and with our adjusted dividend-price ratio for a per-share investor in red. We see in this figure that our adjustment of the trading strategy results in a very different picture of the relationship between fundamental price and observed price after 2000 — our estimate using the dividend-price ratio for a per-share investor shows fundamental price well below observed price (the log ratio is substantially negative) while this is not the case when we consider our adjusted dividend-price ratio (this log ratio is close to zero).

In Figure 4d we show the ratio of total market capitalization to PCE in black and the ratio of fundamental price to PCE in red where we have estimated fundamental price using the dividend-price ratio for a per-share investor with our alternative trading strategy. We see here that the dynamics of fundamental price since 2000 appear to account for a very large portion of the dynamics of observed price. This is a direct consequence of our finding in Figure 4c that the log ratio of fundamental price to observed price using this estimate is close to zero in recent decades. From equation (15), this finding is itself a direct result of

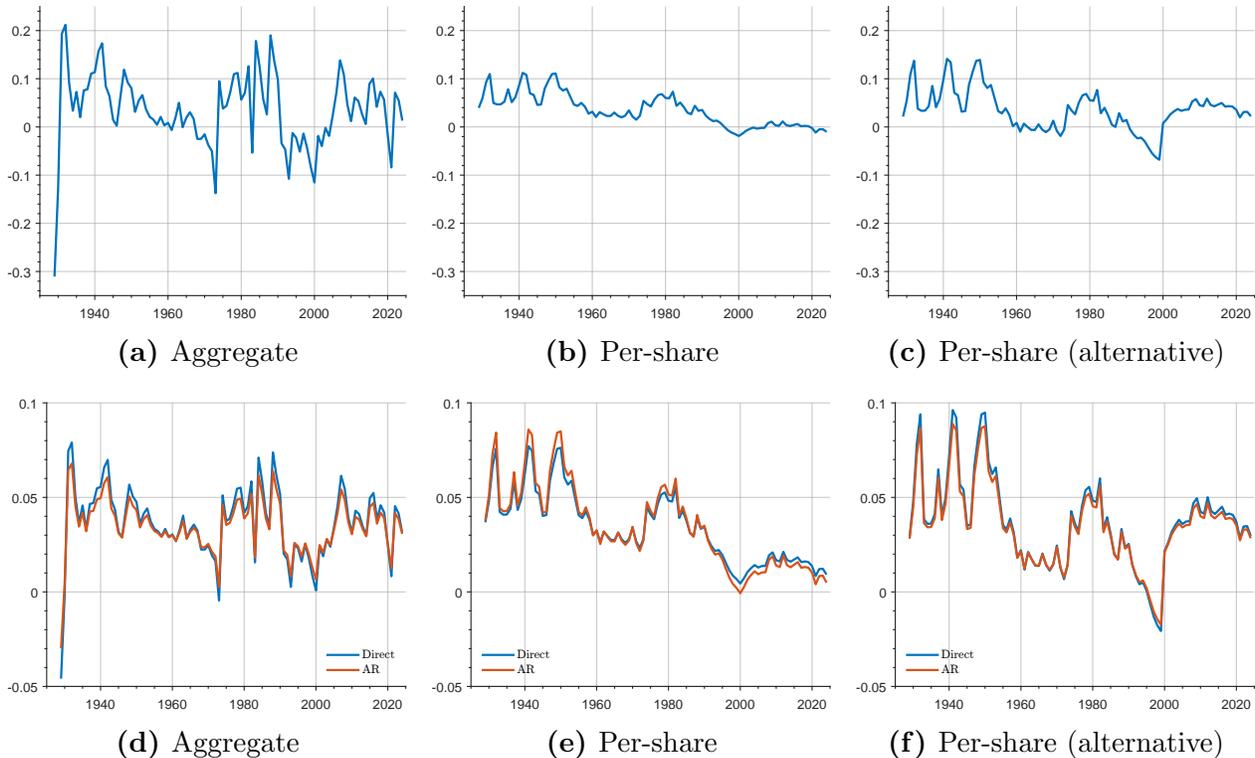


Figure H.1: Annualized expected log returns net of PCE growth estimated using alternative cash-flow-to-value ratios. Top row: one-year-ahead forecasts from direct regressions. Bottom row: ten-year-ahead annualized forecasts from direct regressions (blue) and those implied by the one-year regression and estimated predictor persistence (red). Left panels: cash-flow-to-value for an aggregate investor. Middle panels: cash-flow-to-value for a per-share investor. Right panels: cash-flow-to-value for a per-share investor under the alternative trading strategy.

the observation that our alternative dividend-price ratio is close to its historical mean during this time period and thus our forecast of expected returns is close to its historical mean over this time period.

I Implications of No Forecastability of Dividends per Share

In this appendix, for illustrative purposes, we follow the argument in [Cochrane \(2008\)](#) that the lack of predictability of the growth in dividends per share gives us information on the dynamics of expected returns and hence of the log ratio of fundamental price to observed price. See [Cochrane \(2011\)](#), [Campbell \(2014\)](#), and [Campbell \(2018\)](#) for summaries of this argument. More recent research in this vein has found some evidence of predictability in the growth of dividends per share. See, for example, [Van Binsbergen and Koijen \(2010\)](#), [Kelly](#)

Table H.2: Variance decomposition of log aggregate market capitalization (relative to PCE)

	$Var(\log P_t^*)$	$Var(\log(P_t/P_t^*))$	$Cov(\log P_t^*, \log(P_t/P_t^*))$
Aggregate	0.284	0.020	0.011
Per-share	0.124	0.063	0.070
Alternative	0.233	0.046	0.024

Decomposition is $Var(\log P_t) = Var(\log P_t^*) + Var(\log(P_t/P_t^*)) + 2Cov(\log P_t^*, \log(P_t/P_t^*))$.
 $Var(\log P_t) = 0.3260$.

and Pruitt (2013), and Jagannathan and Liu (2019).

To illustrate the method proposed by Cochrane (2008) consider again equations (5) and (6). If one takes as given that the growth of dividends per share in equation (6) cannot be forecast, then we should consider this term to be a constant over time. From taking logs of the terms in equation (5), we then conclude that the fluctuations in the log of the ratio of dividends per share to price per share on the left side of this equation correspond entirely to fluctuations in the log ratio of fundamental price to observed price. For illustrative purposes, we take the data on the deviations of the log ratio of dividends per share to price per share from its mean as an estimate of the log ratio of fundamental price to observed price, $\log(P_t^*/P_t)$ (we impose that the mean of this series is zero). We refer to this estimate as our estimate obtained using the indirect method of Cochrane (2008).

We note from Figure 2a that there is a clear break in the trend growth of log dividends per share relative to PCE associated with the trend break in the trading strategy of a per-share investor, $\log(S_t)$. Thus, we do not see the claim that the growth of dividends per share is not forecastable as plausible. Hence, we will also construct an alternative indirect estimate of the log ratio of fundamental price to observed price using the dividend per share to price per share series that emerges from our alternative trading strategy described in Appendix G. We refer to this estimate as our estimate obtained using the indirect method of Cochrane (2008) with our alternative trading strategy.

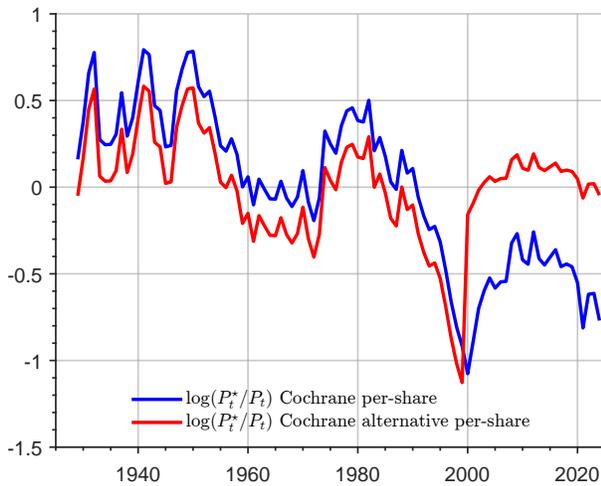
We plot these series for $\log(P_t^*/P_t)$ in the left panel of Figure I.1. Prior to 2000, both sets of estimates indicate large deviations between our estimates of fundamental price and observed price. After 2000, however, it appears that the gaps between observed price and fundamental price are highly sensitive to the data used in estimation. That is, the estimate of fundamental price in blue obtained using the data on ratio of dividends per share to price per share and this indirect method of Cochrane (2008) suggests that the fundamental price has been well below the observed price for the past 30 years. In contrast, if we use the ratio of dividends per share to price per share from our adjusted trading strategy to estimate fundamental price, as in the red line, we see that fundamental price is quite close to observed

price over the past twenty years or more.

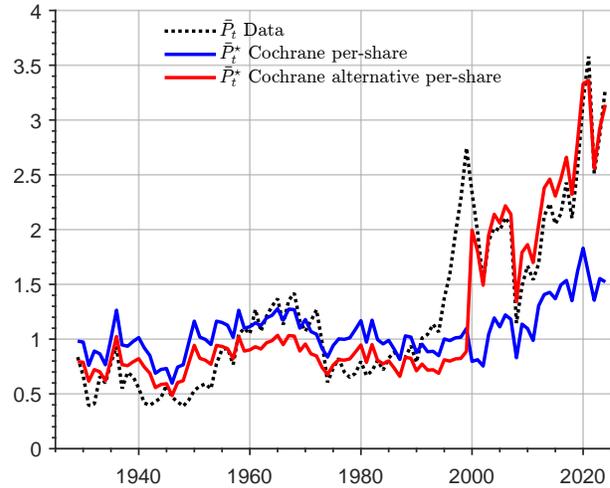
In the right panel of Figure I.1 we show the implications of these estimates for the predicted level of the fundamental component of total market capitalization, relative to aggregate PCE. Using the original per share data, this suggests a rise in fundamental valuations of only around 50 percent between 1990 and 2024. Dividends per share fall well below their historical mean in the post 2000 period (Figure 2d) which the Cochrane approach interprets as a large decline in the ratio P_t^*/P_t , and (equivalently) as a large decline in future expected returns (see equation 7). Thus, the interpretation is that valuations have surged far above the present value of expected cash flows because expected returns have declined.

In contrast, applying the Cochrane view to the alternative per share series attributes all of the surge in valuations over that period to the fundamental component.

Following Campbell and Shiller (1988a), many researchers have focused on decomposing fluctuations in cash flow to value ratios into a component reflecting changes in expected returns versus a component reflecting changes in expected cash flow growth. But the discussion above highlights that this literature does not sufficiently address a more basic issue, which is that the *level* of the cash flow to value ratio depends on the trading strategy. The original dividends per share to price per share series has declined substantially, so if one focuses on that series the question of whether the decline is informative about changes in future returns or changes in future cash flow growth is live and important. But our alternative per share series has barely moved, so if one focuses on that series, the answer to the Campbell-Shiller question is inconsequential: even under the Cochrane view that cash flow growth is unpredictable, one is forced to conclude that the large boom in observed valuations almost entirely reflects a rise in the expected present value of future cash flows.



(a) Estimates of $\log(P_t^*/P_t)$ using the **Cochrane (2008)** approach: $\log(P_t^*/P_t) = \log(D_t/P_t) - \text{mean}(\log(D_t/P_t))$. Blue: original dividends per share relative to price per share. Red: alternative per-share series described in Appendix G.



(b) Total market capitalization (black) and the implied fundamental component \bar{P}_t^* constructed from the two estimates for $\log(P_t^*/P_t)$ shown in Panel (a). All these series are relative to aggregate PCE.

Figure I.1: Estimates of the fundamental price component using the **Cochrane (2008)** approach.

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