

# GREAT EXPECTATIONS

The man behind the Gordon Growth Model.



BY JOHN ILKIW

What level of dividend growth must an investor expect to justify the current price of a stock? This question gave birth in 1956

to the now industry-standard discount growth model that is used to value individual company stocks and the broad equity market, and to estimate the equity risk premium.

In the early '50s, Myron "Mike" Gordon, then assistant professor at the MIT School of Management, wanted to understand why US Steel was trading at a much lower price-earnings ratio relative to IBM, even though the earnings per share of US Steel was much higher than IBM. The answer was both insightful and simple: investors expected dividends to grow more rapidly over the life of IBM than over the life of US Steel. This insight is captured mathematically in the now ubiquitous formula—the expected return to a share of common stock equals the current dividend yield plus the rate at which the dividend is expected to grow—and was published in *Management Science* in a paper titled "Capital Equipment Analysis: The Required Rate of Profit," co-authored with Eli Shapiro.

$$K = \frac{D_1}{P_0} + g$$

Why isn't it called the Gordon-Shapiro Growth Model? Gordon had invited his then-colleague, Eli Shapiro, to help with the model's development but his contribution was very limited, focusing mostly on editorial comments. As Professor Gordon explained during a telephone interview, "This was an opportunity for two friends to collaborate on an idea. Eli was a monetary economist and his contribution was minor at best, but I could not retract my original offer." Gordon's MIT colleagues Paul Samuelson and Robert Solow—both future Nobel Prize winners—also made no contribution to the development of the model. His now famous colleagues were focused exclusively on post-Keynesian macroeconomic

issues. "They had no interest in developing frameworks that helped micro-level economic agents make better applied decisions," Gordon explained to me.

During his eight years at University of Rochester, Myron Gordon and his then-colleague Michael Jensen both observed that large publicly traded corporations were conservatively financed and managed by very experienced and well-paid senior management teams, but teams with little or no equity ownership at risk. Gordon interpreted this benignly, arguing that senior management, with the memory of the pre-World War II depression still fresh in their minds, made decisions to maximize the financial security of their corporations and themselves by ensuring they could survive long periods of economic adversity. Michael Jensen argued the opposite: that this was a clear manifestation of agency risk and management should focus on maximizing current shareholder price. Jensen's interpretation of corporate behaviour prevailed, as demonstrated by the 1970s wave of leveraged buyouts and the growth of the high-profile private equity industry.

A visceral critic of the Vietnam War, and angered with the University of Rochester's active pursuit of military and CIA contracts, Gordon accepted an offer from the University of Toronto in 1970. The Gordon family settled in Toronto and became dual U.S. and Canadian citizens. Myron continued his active research and teaching agenda, was elected President of the American Finance Association in 1975, and became close colleagues with Laurence Booth, Abe Rotstein and Paul Halpern. He was also a leader of the U.S.-Canadian initiative to help transform China's soviet-style business schools to a capitalist focus. He found professors to teach in China and brought the country's best students to study in North America. Gordon received an Honorary Degree from the University of Toronto in 2005 for lifetime contributions to knowledge. Myron now lives with his son in New Jersey, is 86 years old and is a joy to meet. ■

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