



Trading and Investing for Beginners

What's the big deal with Price to earning ratio?

By Eric LeRiche

If you never heard of Price to Earnings Ratio or the "P/E" you definitely aren't an investor!

The P/E is one of those terms that investors use as if it told the whole story but, of course, it doesn't.

What is it anyways?

The P/E ratio shows the relationship between a stock price and its company's earnings (or profits) per share of stock. You calculate the P/E by taking the share price and dividing it by the company's EPS.

$P/E = \text{Stock Price} / \text{EPS}$

For example, a company with a share price of \$20 and an EPS of 4 would have a P/E of 5 (\$20 / 4 = 5).

This means that the level of a company's stock price should largely be based on that company's profit-in-hand (here defined as total profits over the past 12 months).

Earnings are at the heart of the matter of valuing a company's stock. Other measures exist, of course. You might wish to value a real-estate company's stock not off its earnings but off the value of its land. Or take dividends, the annual payments made by a company to holders of its stock. You might wish to value a company that pays a large dividend more off of the value of its dividend than its earnings. Other exceptions exist as well. But they are only exceptions. Users of the P/E ratio have a simple tool at hand that quickly values a company off of earnings.

What does P/E tell you again? The P/E gives you an idea of what the market is willing to pay for the company's earnings. The higher the P/E the more the market is willing to pay for the company's earnings. Some investors read a high P/E as an overpriced stock and that may be the case, however it can also indicate the market has high hopes for this stock's future and has bid up the price for example the market might expect the earnings to rise rapidly in the future (gold mining, pharmaceutical, etc...)

Conversely, a low P/E may indicate a "vote of no confidence" by the market or it could mean this is a sleeper that the market has overlooked. Known as value stocks, many investors made their fortunes spotting these "diamonds in the rough" before the rest of the market discovered their true worth.

What is the "right" P/E? There is no correct answer to this question, because part of the answer depends on your willingness to pay for earnings. The more you are willing to pay, which means you believe the company has good long term prospects over and above its current position, the higher the "right" P/E is for that particular stock in your decision-making process. Another investor may not see the same value and think your "right" P/E is all wrong.

To add to the confusion you'll notice a high PE in one sector could be 20 and in another 100+! These differences are important when doing your due diligence... Historically, at severely high P/E ratios (such as over 100x), a stock has NO (0.0%) or negligible dividend yield. With a P/E ratio over 100x, and supposing a portion of earnings is paid as dividend, it would take over a century to earn back the purchase price. Such stocks are extremely overvalued, unless a huge growth of earnings in the next years is expected. Looking back 20 years at the S&P 500 index, you will find the P/E varied roughly between 10 and 50 with an average of around 15. We are now around 17 but once again, don't forget to compare apples with apples when you analyze a specific company i.e. compare it with its peers....

OK, now, why earnings per share? Why not just consider earnings?

Remember that our ultimate goal is to value a stock, not a company. Stocks are priced per

share. If the number of shares of a given stock suddenly inflates, all other things remaining equal, what will happen to the stock price? It'll drop. Same thing happens to earnings, of course.

And if earnings growth becomes outpaced by share growth, that's tainted growth, from an investor's point of view. That's often a losing situation. Always look at earnings per share.

To finish, let me mention an important problem that arises with the P/E measure, and to avoid basing a decision on this measure alone. The denominator (earnings) is based on an accounting measure of earnings that is susceptible to forms of manipulation, making the quality of the P/E only as good as the quality of the underlying earnings number...

Next time, we'll talk about the Projected Earning Growth -PEG.

See you then and in the mean time, don't forget to protect your capital!

Yours truly,

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