



Trading and Investing for Beginners

What is the PEG?

By Eric LeRiche

In the article on Price to Earnings Ratio or P/E , I mentioned that this number gave you an idea of what value was placed on a company's earnings.

The P/E is the most usual way to compare the relative value of stocks based on earnings since you calculate it by taking the current price of the stock and divide it by the Earnings Per Share (EPS). This helps identify if a stock's price is high or low relative to its earnings.

Some will say a company with a high P/E is overpriced and they may be correct. A high P/E may warn you that traders have raised a stock's price past the point where any acceptable near term growth is feasible.

But, a high P/E may also signal that the company still has strong growth prospects in the future, which could predict an even higher PPS (price per share).

Because the market cares more about the future than the present, it is always looking for some way to predict it...

Another indicator you can use to help you look at future earnings growth is called the PEG ratio. Price/Earnings To Growth, is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share (EPS), and the company's expected future growth. PEG is a widely employed indicator of a stock's possible true value.

You calculate the PEG by taking the P/E and dividing it by the projected growth in earnings.

$$\text{PEG} = \text{P/E} / (\text{projected growth in earnings})$$

For example, a stock with a P/E of 60 and projected earning growth next year of 30% would have a PEG of 2 ($60 / 30 = 2$).

What does the "2" mean? Like all ratios, it simply shows you a relationship. In this case, the lower the number the less you pay for each unit of future earnings growth. Even a stock with a high P/E, but high projected earning growth may be a good value. In other words, a lower ratio is "better" (cheaper) and a higher ratio is "worse" (expensive).

The PEG ratio of one represents a fair trade-off between the values of cost and the values of growth, and then the stock is reasonably valued given the expected growth. Similar to PE ratios, a lower PEG means that the stock is undervalued more. It is favored by many over the price/earnings ratio because it also accounts for growth. If a company is growing at 30% a year, then the stock's P/E could be as high as approximately 30.

PEG ratios between 1 and 2 are therefore considered to be in the range of normal values. A crude analysis suggests that companies with PEG values between 0 to 1 may provide higher returns

Looking at the opposite situation; a low P/E stock with low or no projected earnings growth, you see that what looks like a value may not work out that way. For example, a stock with a P/E of 8 and flat earnings growth equals a PEG of 8. This could prove to be an expensive investment.

A few important things to remember about PEG:

- Investors may prefer the PEG ratio because it explicitly puts a value on the expected growth in earnings of a company. The PEG ratio can offer a suggestion of whether a company's high P/E ratio reflects an excessively high stock price or is a reflection of promising growth prospects for the company.

- The PEG ratio is less appropriate for measuring companies without high growth. Large, well-established companies, for instance, may offer dependable dividend income, but little opportunity for growth.

- A company's growth rate is an estimate.

It is subject to the limitations of projecting future events. Future growth of a company can change due to any number of factors: market conditions, expansion setbacks, and hype of investors.

- The convention that (PEG=1) is appropriate is somewhat arbitrary and considered a rule of thumb metric.

That's it for this week, next time we'll talk about the Price to Sales - P/S.

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

Yours truly,

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