In Brief

A Brief Review of Financial Best Practices.

What is the P/E Ratio?

A growing economy will translate into growth in investments over long periods of time, but it's not always the case that economic growth in one year leads to investment growth in that year. Investment returns are driven by investor expectations about company earnings, interest rates and perceptions of risk.

While it's impossible to predict investment returns, there are ways to analyze whether or not the markets are likely to generate above or below average returns. This requires us to look at the probability that the market will do better or worse than the economy going forward to make informed investment decisions. That's where the P/E ratios comes into play.

What is a P/E Ratio?

P/E is short for the ratio of a company's share price to its per-share earnings. As the name implies, to calculate the P/E, you simply take the current stock price of a company and divide by its earnings per share (EPS):

$$\text{PE Ratio} = \frac{\text{Market Value Per Share}}{\text{Earnings Per Share (EPS)}}$$

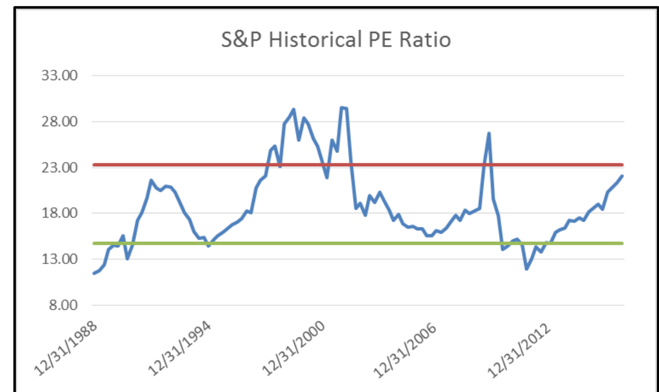
The P/E Ratio is a common way to estimate whether the stock market is under or over-valued. Analysts commonly divide the price of stocks by their earnings to get the price/earnings or PE ratio. This can be done on an individual stock or on the stock market as a whole. Because the owner of a stock has the right to receive a portion of future earnings, the price the investor pays for each dollar of future earnings is a good indication of whether the investor is paying too much or too little.

Three Common Ways Analysts Use the P/E Ratio

Most of the time, the P/E is calculated using EPS from the last four quarters (also known as the trailing PE.) But, sometimes the EPS figure comes from estimated earnings expected over the next four quarters (also know as the leading or projected P/E). Some advisors even use a third variation– using the EPS from the past two quarters and estimates of the next two quarters.

It is important to note that in the first calculation, you are using actual historical data. The other two calculations are based on analyst estimates that are not always perfect or precise.

Using estimates may be a valuable practice for an investor that follows only a handful of companies and has a unique ability to predict a company's future earnings. However, when looking at the stock market as a whole, earnings tend to grow on a consistent basis, and past earnings are a very good predictor of future earnings.



The graph above shows the historical PE ratio of the S&P 500 from 1988 through 2016. The red line shows the top 85th percentile (the ratio was above this 15% of the time) and the green line is the 15th percentile (the PE was below this 15% of the time).

When the PE ratio is high (i.e. above the red line), there's less chance that the PE ratio will continue to go up. However, just because there is less likelihood that the PE ratio might increase doesn't mean that we don't expect stock prices to increase. If earnings increase, the stock prices can go up without increasing the PE ratio.

This is a very quick look at the PE ratio, and obviously any complete analysis of stock values would have to consider other factors like interest rates, government policy, economic and productivity growth, and potential shocks or risks. However, if you want a simple tool to help you know generally when you are buying low or selling high, the PE ratio is very useful.

To learn more about PE Ratios call Tim Obendorf at 630-537-0111 or email: Tim@StewardAdvisors.com.