UNDERSTANDING PRICE TO EARNINGS RATIOS

Retirement Income Source®

Understanding Price-to-Earnings Ratios

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Have you ever bought a pair of pants for your child or grandchild that were too big? It's a common occurrence, and when it happens, you have two options: 1) you can throw the pants in the wash and try to shrink them, or 2) you can just sit back knowing that your child or grandchild will eventually grow into them. This same phenomenon applies when the price of stocks gets overinflated in relation to annual corporate profits. If you can learn to recognize when it's happening, that knowledge can go a long way toward helping you make smart savings and investment decisions.

In 1998, the overall price of stocks in the market was becoming overinflated – like a baggy pair of pants – relative to actual corporate profits. With knowledge of market history and a grasp of basic financial ratios, an investor could have anticipated that one of two things were likely to happen to correct this growing imbalance. Either overall stock prices had to drop, or we had to slip into a period of market volatility while we waited for corporate profits to grow into these baggy price levels.

The Formula

Every stock has a price-to-earnings ratio, and so does the entire stock market. The formula is simple: price per share divided by earnings per share. By comparing these two measurements in one stock and calculating the ratio alongside that of another stock, you can often get an idea of which stock is a better buy. As a very general rule of thumb, the stock with the lower price-to-earnings ratio is the more attractive stock because it is considered undervalued, and remember, the goal is always to "buy low."

For instance, let's say you have a stock selling at $30 per share in a company whose corporate earnings are $1 per share. Then you have a stock selling at $50 a share in a company whose corporate earnings are $5 a share. Which one is the bargain? Well, it's the second one with the higher-priced stock. That's because 50 divided into 5 is 10, while 30 divided into 1 is 30. Ten is lower than 30, and thus, that's a lower price-to-earnings ratio. Now, it's important to remember that in the real world, there is a lot more to consider than simply P/E ratios when choosing which stock to buy, but it is something you want to understand.

A Good Indicator

Again, both individual stocks, and the market overall, have a P/E ratio, and if you keep track of the overall ratio, it can give you a good indication of when stock market levels are generally too high and ready for a drop. If you look at stock market history, it shows that, typically, when a long bull market cycle is nearing its end, P/E ratios overall are near or above 30. In other words, history tells us a market P/E ratio of 30 or above could be a warning sign that the market is about to drop. Why 30? Because at that point, the imbalance in the price-to-earnings formula is bordering on ridiculous. Here's an analogy to help explain why:

Suppose you decided to buy an ice cream parlor and the owner wanted a cool $3 million for it, and you knew the business consistently earned $100,000 annually. That's a P/E ratio of 30, which means it would take you 30 years to recoup your investment and hopefully start turning a profit. Does that sound like a good investment — or does it sound a bit ridiculous?

Now, let's look at the opposite end of the P/E spectrum. Typically, toward the end of a long bear market cycle for the stock market, price-to-earnings ratios slip below 10, very often into the 6 to 8 range. Historically, that's been a key signal that the next bear market cycle of steady growth is about to begin.

Summary

The bottom line is that P/E ratios can, and do, help serve as a good indicator of where the markets may be heading. However, they are, of course, just one of many such indicators, and no indicator is 100% accurate every time.

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