The Stan Clark Financial Team's

PERSPECTIVES

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Investing

More evidence favouring low P/E investing (Part 2 of 2)

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Last month we discussed investing in companies with low price-to-earnings ratios, that is, companies that are out of favour. We saw how investing in low P/E companies results in good, long-term performance.

In this month's article, we discuss more evidence that favours low P/E investing.

Jim O'Shaughnessy, author of *What Works on Wall Street*, has done significant research on P/E and subsequent performance. O'Shaughnessy says investors who buy low P/E stocks are usually getting a bargain. These stocks tend to be improperly discounted, and when earnings recover the stock price will follow. On the other hand, investors who buy high P/E stocks often have unrealistic expectations that are unfulfilled – along with the stock price.

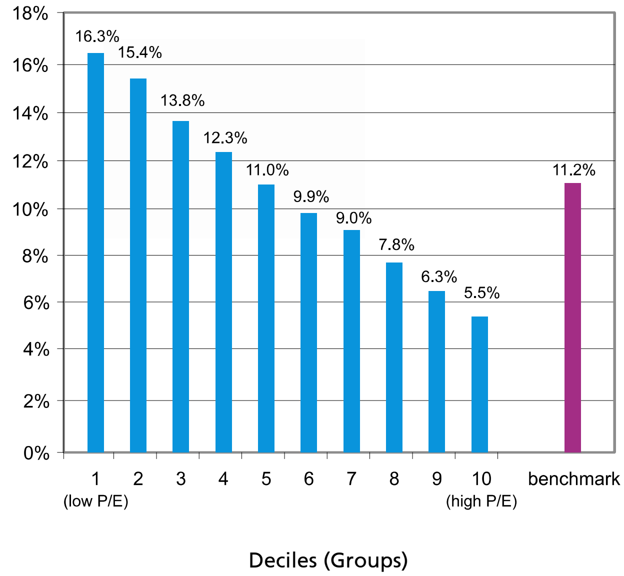
O'Shaughnessy's study ran from 1964 to 2009. He divided stocks into 10 groups, or deciles, based only on P/E. Investing in the lowest P/E group returned 16.3% versus 11.2% for the market benchmark. Interestingly, the lowest P/E group also had lower risk. This group had lower volatility, more positive periods and fewer negative periods when compared to the benchmark.

These results were also quite consistent over the 46-year study. Looking at one year at a time, we see that this strategy of low P/E investing beat the benchmark 75% of the time, on average by about 4.8% per year. Looking at three-year periods, we see that the strategy beat the market 86% of the time, by almost 5% per year. The trend continues. For 10-year periods, the strategy beat the market in almost every period, again by about 5% per year.

Let's look at the other end of the spectrum, and review the performance of the high P/E group. This group returned 5.5% versus 11.2% for the benchmark. Risk measures were also worse: higher volatility, fewer positive periods and more negative periods. Looking at one-year periods, high P/E stocks underperformed 67% of the time, on average by about 3.3% per year. Over three-year periods, high P/E stocks underperformed 80% of the time, by more than 5% per year. In 10-year periods, high P/E stocks only beat the market one time out of 433 periods.

So far this is pretty convincing evidence on the predictive ability of the P/E ratio. But could it be that these are just anomalies? Let's look at the remaining groups between high and low P/E.

The chart below shows the performance of each group. Notice how the performance is best for the lowest P/E group, and then it declines gradually and sequentially until we get to the high P/E group. This is important as it shows us that the P/E ratio has good predictive ability and consistent performance. It's also important in that it makes sense: With low P/E investing you are essentially paying less per dollar of earnings compared to the average stock.



Source: James O'Shaugnessy

All this doesn't make investing easy. The strategy isn't perfect and will underperform from time to time. So we still need to be disciplined and patient.

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