The Stan Clark Financial Team's

PERSPECTIVES

An excerpt from "Perspectives" - Volume 6 – Issue 9

Investing

Low P/E vs. high P/E investing

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The price-to-earnings ratio, also known as P/E, is a company's price divided by its earnings. We use it in our stock selection strategies to compare valuations. Low P/E companies are considered cheap, while high P/E companies are considered expensive. So, which is better?

Low P/E companies might be cheap, but maybe they're shunned for good reason. Perhaps their future prospects aren't very bright. Maybe high P/E companies are better, since everyone seems to be excited about them.

Let's look at the numbers. There are numerous studies that examine the relationship between P/E and subsequent performance. Research into P/E ratios started in the 1960s. In his book *The Intelligent Investor*, Benjamin Graham, the father of value investing and mentor to Warren Buffett, cited a study involving the 30 stocks of the Dow Jones Industrial Average. Graham compared the performance of the 10 lowest P/E stocks to that of the 10 highest P/E stocks between 1937 and 1969. In every five-year period, low P/E stocks did better than the market, and high P/E stocks did worse. A number of other studies from the 1960s came up with similar conclusions. Yet these studies are old. Surely things have changed since then? But perhaps not!

Enter David Dreman, who is regarded as the dean of contrarian investing. Dreman wrote much about the concepts of behavioral finance even before it was known as behavioral finance. He has done numerous studies on low P/E strategies. In one, he studied the 1,800 largest companies from 1963 to 1985. Dividing the companies into five groups based on P/E, he found the lowest P/E group outperformed the average and substantially outperformed the highest P/E group. Later, he did a larger study, taking 6,000 companies from 1968 and 1989, and dividing them into five groups based on company size. Then Dreman sub-divided each of these groups into five more groups, based on P/E. Again, the low P/E groups did much better than the high P/E groups, regardless of company size. Interestingly, he also found that low P/E groups were lower risk.

So far we've shown that low P/E investing has worked well from the 1930s up to 1990. This long track record gives us confidence with this method. Still, a lot has happened since 1990: the dot-com boom and bust, and more recently the sub-prime mortgage and sovereign debt crisis. Let's take a look at a more recent study to see if success with low P/E investing has persisted. This study covered 1,500 stocks from 1970 to 2010. The results were consistent with the older studies: Low P/E companies outperformed and high P/E companies underperformed.

There's definitely a consistant message. Low P/E stocks do better. So why doesn't everyone use this information? Here is where behavioral finance comes in. While all the statistics tell us to invest in low P/E companies, our emotions drag us the other way. People are captivated by what's trendy and popular. They want to stay away from companies that are boring or have less-than-stellar outlooks. While using a simple rule like "buy low P/E stocks" has resulted in better-than-average returns, most people still have a hard time sticking with it.

We expect that the benefits of low P/E will persist. Most people don't realize how limited they are as forecasters. They tend to extrapolate positive or negative outlooks well into the future, pushing the prices of favoured companies into excessive premiums and out-of-favour companies into deeper discounts. As long as people think they can pinpoint the future of individual stocks, the success of low P/E investing should continue.

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