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Investing

# Behind the Numbers: Price-to-earnings ratio (part two)

*By Michael Chu, Investment Advisor*

**The *price-to-earnings ratio*, also known as P/E, is a company's share price divided by its annual earnings per share. In part two of our series "Behind the numbers," we discuss the P/E ratio – and its importance in evaluating companies.**

If a company has a price of $30, and annual earnings of $3 per share, then the P/E ratio is 10 times. That would typically be considered low, or cheap. If another company has the same share price, but earnings of only $1 per share, then the P/E ratio would be 30 times. All else being the same, that would typically be considered high, or expensive.

Another way of presenting P/E is the earnings yield. Earnings yield is the inverse of P/E: earnings divided by price. So, a low P/E stock has a high earnings yield. In our example of the company with a P/E of 30, the earnings yield would be 3.3%.

The P/E ratio tells you how much you are paying for every dollar of earnings. It also enables you to compare the valuation of one company to another – perhaps in the same industry, or to a completely different stock, or to itself historically. All things being equal, a company with a P/E ratio of 30 is three times as expensive as a company with a ratio of 10, even though they are both $30 per share. You might wonder why some stocks have high P/E ratios, while others have low ones. Usually, stocks with higher P/E ratios also have higher growth prospects. Those with low P/E ratios would typically have lower growth prospects.

We often hear about *value stocks* and *growth stocks*. Value stocks are typically those with low P/E ratios. Value investors like these stocks. They believe they are getting good value because they are paying below-average prices for earnings. They don't want to depend on, or pay more for, future earnings growth that seems too unpredictable or overestimated. Growth investors are on the other end of the spectrum. They are willing to pay more for companies that are poised for significant growth. If such growth materializes, it should result in good price appreciation.

So, how do we use the P/E ratio to select stocks? P/E ratios and stock selection have been the subject of numerous research studies. One long-term study looks at all U.S. stocks over 46 years, from 1963 to 2009. The study separates the stocks into 10 groups, based on P/E ratios. It shows that low P/E stocks had returns of 16.3%, while high P/E stocks had returns of 5.5%. The market average for this period was 11.2%. Clearly, low P/E stocks outperformed high P/E stocks – and, more importantly, they also outperformed the market.

There's one thing we should point out about testing variables like P/E: Just because there is a pattern doesn't necessarily mean that it's a good variable to use. There might not be a causal relationship. For example, let's say we discover a strong pattern between stock returns and the weather. We wouldn't consider using this as a variable because it doesn't make sense; it is just a coincidence. By contrast, the reasoning behind P/E being a useful variable is sensible and sound. You are paying less for the same dollar in earnings compared to an average stock. You may recall from our discussions on behavioral finance that going counter to the popular trend can be rewarding.

While value investing has a strong track record over the long term, keep in mind that investment styles can come in and out of favour, and one style can outperform the other for extended periods. Our stock strategies have a value bias, but still combine factors from both styles of investing for diversification. ■

*Michael Chu is a Portfolio Manager and Investment Advisor for the Stan Clark Financial Team at CIBC Wood Gundy. Michael is a specialist in investment research and information technology.*

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Phone: (604) 641-4361 Toll free: 1 (800) 661-9442 Fax: (604) 608-5211 Email: StanClarkFinancialTeam@cibc.ca www.stanclark.ca