Stan Clark - Low PE vs. high PE investing.mp4

Speaker1: The price to earnings ratio, also known as P is a company's price divided by its earnings. We use it in our stock selection strategies to compare valuations. Low PE companies are considered cheap, while high p e companies are considered expensive, but which is better. Hi, I'm Michael Chu. Low PE companies might be cheap, but maybe they're SHONN 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 and subsequent performance research into P e ratios started in the 60s. 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 compare the performance of the 10 lower SPX stocks to that of the ten highest stocks between nineteen thirty seven and nineteen sixty nine. In every five year period. Low PE stocks did better than the market and high PE stocks did worse. A number of other studies from the 60s came up with similar conclusions. Yet these studies are all surely things have changed since then, but perhaps not enter David Dreman, who is regarded as a dean of contrarian investing.

Speaker1: Trymaine wrote much about the concepts of behavioral finance even before it was known as behavioral finance. He has done numerous studies on collopy strategies and one he studied the eight hundred largest companies from nineteen sixty three to nineteen eighty five, dividing the companies into five groups based on P. He found that the lowest P group outperformed the average and substantially outperformed the highest P group. Later, he did a larger study taking 6000 companies from nineteen sixty eight and nineteen eighty nine and dividing them into five groups based on company size, then dreman subdivided each of these groups into five more groups based on P. Again, the low P groups did much better than the high P groups, regardless of company size. Interestingly, he also found that the low P groups were lower risk. So far we've shown that low P investing has worked well from the nineteen thirties up to nineteen ninety. This long track record gives us confidence with this method. Still, a lot has happened since nineteen ninety, the dot com boom and bust and more recently the subprime mortgage and sovereign debt crisis. Let's take a look at a more recent study to see if the success with low P investing has persisted.

Speaker1: This study covered fifteen hundred 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 constant message. Low P stocks do better. So why doesn't everyone use this information? Here's 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 Bilal 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 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 favorite companies into excessive premiums and out of favor companies into deeper discounts. As long as people think they can pinpoint the future of individual stocks, the success of low P investing should continue.