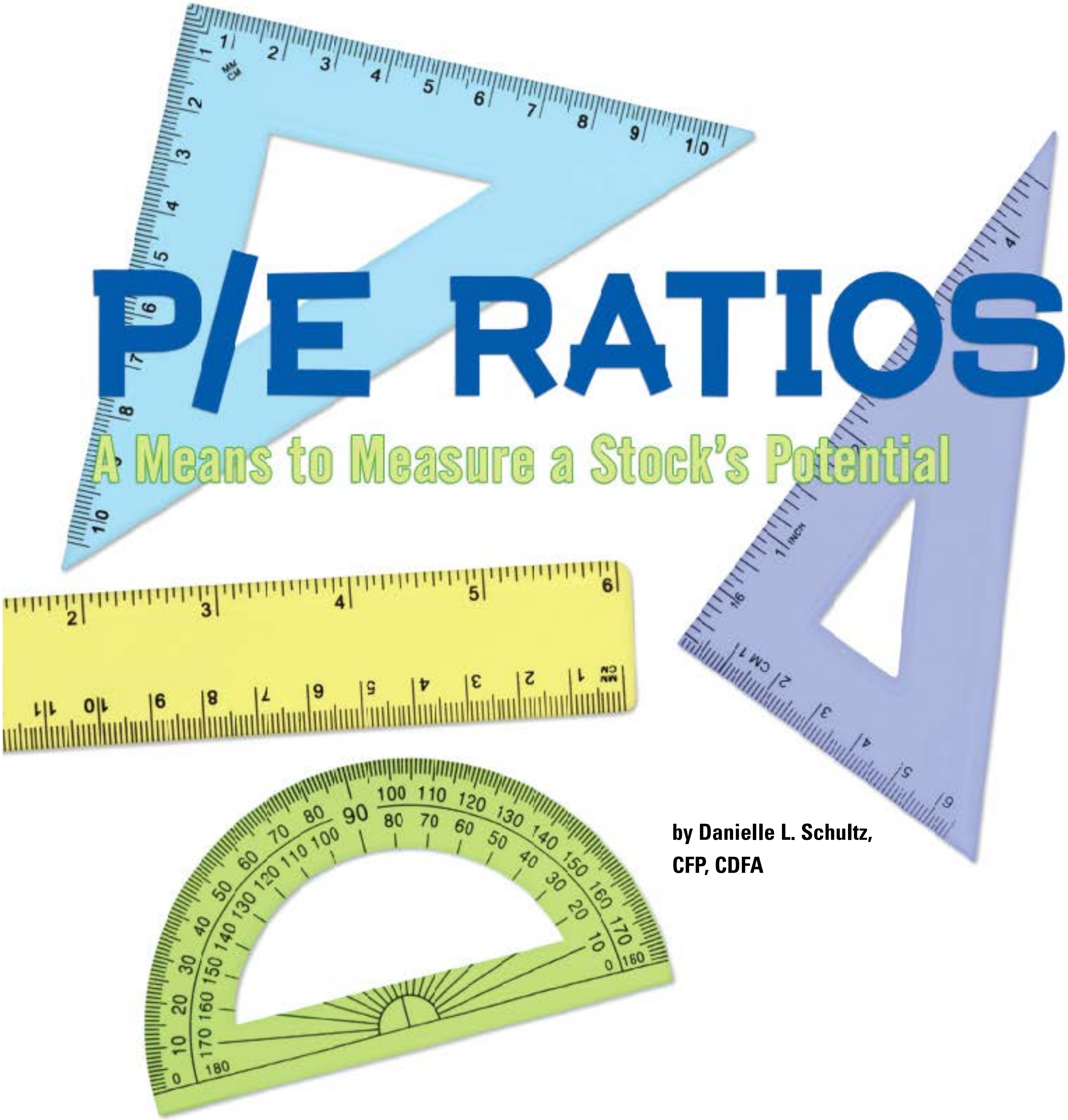

P/E RATIOS

A Means to Measure a Stock's Potential

by Danielle L. Schultz, CFP, CDFA

This time it's different. Whenever the market reaches new highs or new lows, or a specific sector shows dramatic performance, that's the first phrase you'll hear from media gurus, your co-workers and your brother-in-law, the stockbroker. Could they be right? How will you know?

A price-earnings ratio can tell us about both the possibilities of an individual stock and the relationship of that particular investment to the expectations and performance of the entire market. We can do this by gathering data about the overall market, then using BetterInvesting methods to evaluate the particulars.

Many BetterInvesting members are wary of stocks at a P/E above 30 or so unless there's a very good reason to believe a higher P/E is justified. It's a reality check and discipline that's designed to prevent us from being overly enchanted with hype and fashion.

Investors may have reason to select investments with higher expected P/Es, but this should be a carefully considered decision.

Getting the Big Picture

First, you need to have some idea of the current situation. A web search can easily turn up the current P/E of the Standard & Poor's 500 index, the index most commentators are referring to when they talk about "the market." I believe our current market reflects too much investment money chasing too little return. Earnings per share are being driven up for some stocks by share buybacks that change the numbers without the underpinning of real growth (see p. 36).

Investors, both individuals and institutions, are pushing back against ultra-low interest rates by looking for dividend and appreciation in the stock market. Investors are paying high prices for the hope of future growth, dividend increases and therefore improved returns.

Is it wishful thinking?

The S&P 500 P/E offers a snapshot of the current state of affairs, but another useful formulation is the cyclically adjusted price-earnings ratio maintained by Nobel-Prize-winning economist Robert Shiller. It differs from the S&P 500 P/E (based on the trailing 12 months) by being an inflation-adjusted average of 10 years of earnings.

As we all have been warned many times, past performance is no sure indicator of future performance. But the CAPE does reflect a picture over a longer term, hopefully smoothing out short-term trends and showing how current conditions compare with the longer-term picture.

Shiller's research indicates that the higher the CAPE, the lower the returns of stocks (as represented by the S&P 500) going forward. You can see the smoothing effect of the longer-term CAPE compared with the shorter-term S&P extreme during 2009 (see above graphic).

While puzzling out the ramifications of the P/E or CAPE, also consider that as inflation rises, these indicators tend to rise and vice versa. The price of a stock is impacted by what investors think earnings will be worth (present value of future earnings).

Typically in a high-inflation environment, future earnings will have less spending power, and this drives down price and P/E. In part because we currently have low inflation, P/E ratios have climbed higher.

S&P 500 P/E Ratio Compared With Cyclically Adjusted Price-Earnings (CAPE)

	Lowest	Highest	Current (July 15, 2016)
S&P 500 P/E	5.31 (Dec. 1997)	123.73 (May 2009)	24.98
CAPE	4.78 (Dec. 1920)	44.19 (Dec. 1999)	26.90

Source: multpl.com

Drilling Down

Even though the S&P 500 is often considered the entire market, we all know it isn't. You can also review data on P/Es for specific regions, industries and sectors.

For example, could valuations in international developed or emerging markets be considered relatively cheap compared with those in the domestic market? As of June 30, the P/E for international developed markets was 19.9 and was 15.2 for emerging markets, Star Capital Research finds. It's important to realize that investor sentiment can have a strong impact on the "P" even if earnings are good.

Many websites also calculate the P/E and CAPE for various industries and sectors, giving you some indication of what might be overvalued relative to the market and what might seem to be better values. But some sectors, such as real estate, have perennially high P/Es and CAPEs, so it's wise to look at the historical trend for the industry as well as for the overall market.

Coverage of mutual and exchange-traded funds usually includes a price/projected earnings ratio. The CAPE and most versions of the S&P 500 P/E are calculated on past earnings. Projected earnings are predictions based on analysts' forecasts, so take them with a grain of salt.

Analysts have often been shown to be optimistic about a company's prospects. If you compare the price/projected earnings ratio for an index fund that closely tracks its benchmark, however, you can get some idea of how that sector might perform or at least what analysts are predicting going forward.

For example, the ratio for Vanguard FTSE Emerging Markets ETF (ticker: VWO) is currently 12.5. I doubt anyone will be surprised that most analysts are bearish on emerging markets at the moment.

Whenever we look at P/Es, we can't use them as an absolute yardstick. Instead, use them as an early evaluation tool, then search for explanations. As we know from using the Stock Selection Guide, a low P/E can indicate a bargain or a company in deep trouble, while a higher P/E isn't uncommon in rocketing growth stocks. When considering a P/E for a specific company, it's useful to know how it compares with the P/E for its industry and how the industry P/E compares with that of the overall market — and of course how the overall market P/E compares with that of historical levels.

Another financial pundit, Michael Kitces, has proposed turning the CAPE upside down to present a different perspective on the return of a company. Instead of price divided by earnings, Kitces suggests earnings divided by price.

Let's say we have a stock selling for $30.23 per share, with earnings per share of $2.95. The P/E of that stock is about 10.2 (low), but the earnings divided by price gives us a value of 9.75 percent. Compare this with another stock selling for $239.18 with earnings of $5.40 and a P/E of 44.3. That stock ends up with an "E/P" of 2.25 percent.

If a single-number P/E seems confusing, reinterpreting the ratio gives us a picture of return that we can easily understand. Note that this isn't the dividend yield of a stock, but the performance or expectation of earnings growth.

Kitces terms this earnings yield, which can be eventually paid as dividends, reinvested in the business or some combination of the two. The second stock, by the way, is one that's recently been touted by the media as hot. But if you think this indicates the potential forward return on investment, it might shake your expectations a bit.

Getting Specific

The sociologist Emile Durkheim long ago showed us that what you can predict about group behavior cannot necessarily predict the behavior of any individual member.

So, too, with stocks. We can consider market and industry trends, but we have to undertake a specific examination of the stocks we're considering. Market and industry trends give us the broad bands in which a company is likely to function, but we then look to select the best performing segments — or those we believe have the best potential — and the best performing individual companies within those segments. It's worthwhile to check resources such as Value Line to get input on hot stocks in hot industries.

Of course, if you choose a contrarian stance, you should have a well-founded and well-researched belief that an industry or company will turn around.

There's a frequently quoted axiom that bad companies are good stocks because they have nowhere to go but up — unless they go bust. You need to do your homework to make a decision on which condition you're looking at.

> "Where very low P/Es are the 'new normal,' investors fear the market could go even lower."

Once you're evaluating a few stocks, you need to make some judgment calls for selecting the appropriate high and low values for price and earnings. In a market where P/Es have achieved higher-than-normal averages, you might want to be particularly conservative in selecting future high values.

On the other hand, if there does seem to be a rising trend in P/Es in general over a fairly long term, you might be willing to go higher in your predicted P/Es.

Although the SSG is based on numbers and calculations, there's a great deal of judgment you're still called upon to exercise. No matter the market, the investor is always faced with a dilemma. In markets where very low P/Es are the "new normal," investors fear that the market could go even lower or even stagnate for long periods, delivering mediocre or worsening returns. This was the case in the 1970s. On the other hand, investors who pass up some investments with high P/Es have watched in dismay as the stock price goes even higher.

In the market, as in most situations in life, our satisfaction and potential is based on choosing the best available to us in the present moment. The theoretical "best time" to buy or sell will never be now — it will always be some other, illusory time (usually in the past). Although we aim to invest long term at relatively low prices, we also try to invest regularly in the present under current conditions.

When we're in an environment with falling prices and low P/Es, we must muster the courage to invest. When we're in an environment as at present when P/Es are high, we must recognize that there's still investment potential. We should search for good values in quality companies with P/Es that seem attractive (lower than the average for the market, the industry and competitors), recognizing that while we may have to tolerate somewhat lower returns, we can still find profitable investments.

Resources

- **Michael Kitces' blog Nerd's Eye View**
  The website **www.kitces.com** is primarily dedicated to helping financial advisers serve their clients, but it also offers some thought-provoking posts for all investors.

- **BetterInvesting Webinars**
  The organization has sessions available that discuss picking future P/Es. Check out the "Estimating Future P/Es" recording in the Introduction to the SSG Series, available in your My Classes webpage at the website.

- **Historical Perspective**
  For a historical look at the ideas discussed here, take a look at the BetterInvesting article "P/Es in Perspective" by Donald T. Spindel (available in the magazine's section on BetterInvesting's website). Published in August 2008, just before the height of the last financial crisis, it seems prescient and just as relevant today. ■

Investments and opinions are mentioned for educational purposes only; no investment recommendations are intended.

Danielle L. Schultz, CFP, CDFA, is a fee-only financial adviser with Haven Financial Solutions, Inc., based in Evanston, Ill. She can be reached at www.HavenFinancialSolutions.com.