



Fisher Funds

Investor Education Centre

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Price to Earnings Ratio or PE

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One of the most widely used tools for share market investors is the price-to-earnings ratio, the PE. The PE compares a company's share price (P) to its earnings per share (E), and can be used to determine whether a stock is expensive or not.

A lower PE is considered more attractive because you obviously want more earnings for every dollar you invest.

The PE is a much better indicator of the value of a stock than a share price. A \$1 stock with a PE of 40 is much more "expensive" than a \$10 stock with a PE of 6. You are paying more for the \$1 stock's future earnings stream.

The PE ratio doesn't tell you a whole lot on its own, but it is useful to compare the PE ratios of other companies in the same industry, or to the market in general, or against the company's historical PE ratios. A PE provides just a single snapshot picture and should, like all financial indicators, be viewed over time, to look for a trend.

A rule of thumb is that a company's PE ratio should be equal to or less than that company's growth rate.

For example, Trustpower earned 29 cents per share in the year to 31 March 2009. Its share price is currently around \$7.60, so its PE ratio is $\$7.60/\$0.29 = 26$. Compare this with Contact Energy which earned 40 cents per share in the last year. At its current share price of \$6.15, it is trading on a PE of 15 which makes it more attractive than Trustpower, right? Not necessarily.

Trustpower has grown its earnings by 14% over the past two years and is forecast to grow earnings by more than 30% in the next two years. Contact has not achieved earnings growth over the past two years and is forecast to grow earnings by 16% in the coming two years. Even though Contact has a lower PE, Trustpower might be the better investment because it will grow its earnings faster and at the end of the next year, its PE will be low. Rather than relying solely on a stock's historical PE, it is better to use the forward PE because it uses next year's forecast earnings for the "E" part of the equation.

Another thing to be careful of is the definition of earnings. We have talked before about how cash can mean different things to different people. We prefer to focus on the folding stuff, the cash available to a company to use to buy things or distribute to shareholders. Similarly, the earnings should be the real cash profits that a company can make, rather than one-off profits or non-cash items.

The PE is most useful if you can understand just how a company is going to achieve their profits and grow them. To do this, you need to study the underlying business and understand its profit margins, its competitive position, its sales strategy etc. This fundamental analysis goes a long way toward putting the PE in its proper perspective.

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