Beware False Signals From the P/E Ratio

By Ben McClure | Updated December 14, 2017

The price-to-earnings (P/E) ratio is a fairly simple tool for assessing company value. Judging by how often the P/E ratio gets touted—by Wall Street analysts, the financial media and colleagues at the office water cooler—it's tempting to think it's a foolproof tool for making wise stock investment choices. Think again—the P/E ratio is not always reliable. There are plenty of reasons to be wary of P/E-based stock valuations. (See also: *Financial Ratios*.)

Calculating the P/E Ratio: A Quick Review

On the surface, calculating price to earnings is fairly straightforward. The first step in generating a P/E ratio is to calculate earnings per share (EPS)**.** Typically, EPS equals the company's after-tax profits divided by the number of shares in issue.

EPS = Post-Tax Profits / Number of Shares

From the EPS, we can calculate the P/E ratio. The P/E ratio equals the company's current market share price divided by the earnings per share for the previous year.

P/E = Share Price / EPS

The P/E ratio is supposed to tell investors how many years' worth of current earnings a company will need to produce in order to arrive at its current market share value. So, let's say the imaginary company Widget Corp. earned $1 per share over the past year and it's trading at $10.00 per share. The P/E ratio would be $10/$1 = 10. What this tells us is that the market prices it at 10 times earnings. Or in other words, for every share purchased, it will take 10 years of cumulative earnings to equate to the current share price. Naturally, investors want to be able to buy more earnings for every dollar they pay, so the lower the P/E ratio, the less expensive the stock.

The ratio sounds simple enough, but let's look at some of the dangers associated with taking P/E ratios at face value.

The first part of the P/E equation—price—is straightforward. We can be fairly confident what the market price is. On the other hand, coming up with an appropriate earnings number can be tricky. You have to make a lot of decisions how to define earnings.

What's In Those Earnings?

For starters, earnings aren't always clear cut. Earnings can be affected by unusual gains or losses which sometimes obscure the true nature of the earnings metric. What's more, reported earnings can be manipulated by company management to meet earnings expectations, while creative accountingchoices—shifting depreciation policies or adding or subtracting non-recurring gains and expenses—can make bottom line earnings numbers bigger and, in turn, P/E ratios, smaller and the stock appear less expensive. Investors need to be wary of how companies arrive at their reported

EPS numbers. Appropriate adjustments often have to be done in order to obtain a more accurate measure of earnings than what is reported on the balance sheet.

Trailing or Forward Earnings?

Then there is the matter of whether to use trailing earnings or forward earnings figures. Located right in the company's latest published income statement, historic earnings are easy to find. Unfortunately, they are not much use for investors, since they say very little about what earnings are in store for the year and years ahead. It's the company's future earnings that investors are interested in most since as they reflect a stock's future prospects. Forward earnings (also called future earnings) are based on the opinions of Wall Street analysts. Analysts, if anything, typically tend to be overoptimistic in their assumptions and educated guesses. At the end of the day, forward earnings suffer the problem of being a lot more useful than historic earnings but prone to inaccuracies.

What About Growth?

The biggest limitation of the P/E ratio: It tells investors next to nothing about the company's EPS growth prospects. If the company is growing quickly, you will be comfortable buying it even it had a high P/E ratio, knowing that growth in EPS will bring the P/E back down to a lower level. If it isn't growing quickly, you might shop around for a stock with a lower P/E ratio. It is often difficult to tell if a high P/E multiple is the result of expected growth or if the stock is simply overvalued.

A P/E ratio, even one calculated using a forward earnings estimate, doesn't always tell you whether or not the P/E is appropriate to the company's forecasted growth rate. So, to address this limitation, we turn to another ratio, the PEG ratio:

PEG = PE/forecast EPS growth rate over the next 12 months

In a nutshell, the lower the PEG ratio, the better. A PEG of 1 suggests that the P/E is in line with growth; below 1 implies that you are buying EPS growth for relatively little; a PEG greater than 1 could mean the stock is overpriced. However, even when the P/E ratio is standardized for growth, you are basing your investment decision on outside estimates, which may be wrong. (See also: *PEG Ratio Nails Down Value Stocks*.)

What About Debt?

Finally, there's the tricky issue of a company's debt load. The P/E ratio does nothing to factor in the amount of debt that a company carries on its balance sheet. Debt levels have an impact on financial performance and valuation, yet the P/E doesn't allow investors to make apples-to-apples comparisons between debt-free firms and those bogged down with outstanding loans and liabilities.

One way to address this limitation is to consider a company's enterprise value or EV in place of its Price (P).

(simplified) EV = Market Capitalization + Net Debt

Let's say the Widget Corp., with a market share price of $10 per share, also carried the equivalent of $3 per share of net debt on its balance sheet. The

company, then, would have total enterprise value of $13 per share. If Widget Corp. produced EPS this year of $1, its P/E ratio would be 10. But more sophisticated investors would perform the calculation with enterprise value in the numerator and EBITDA in the denominator.

The Bottom Line

Sure, the P/E ratio is popular and easy to calculate. But it has big shortcomings that investors need to consider when using it to assess stock values. Use it carefully. No single ratio can tell you all you need to know about a stock. Be sure to use a variety of ratios to get a fuller picture of financial performance and stock valuation.

Read more: Beware False Signals From The P/E Ratio https://www.investopedia.com/articles/fundamental-analysis/10/false-signals-pe-ratio.asp#ixzz53HS4POXC

What is an 'Earnings Estimate'

An earnings estimate is an analyst's estimate for a company's future quarterly or annual earnings. Future earnings estimates are arguably the most important input when attempting to value a firm. By placing estimates on the earnings of a firm for certain periods (quarterly, annually, etc), analysts can then use cashflow analysis to approximate a fair value for a company, which in turn will give a target share price for publicly traded companies.

BREAKING DOWN 'Earnings Estimate'

Analysts use forecasting models, management guidance and fundamental information on the company in order to derive an estimate. Market participants rely heavily on earnings estimates to gauge a company's performance when announcing quarterly or annual results. The analysts' earnings estimates are used as a benchmark to measure a firm's performance relative to how experts expected it would do.

Read more: Earnings Estimate https://www.investopedia.com/terms/e/earningsestimate.asp#ixzz53HSst93I