Assessing Price-Earnings Ratio

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The price/earnings ratio (P/E) reveals the relationship between the price of a stock and the income it generates.

P/E is one way of looking at the value of a stock. In theory, the faster investors expect a company to grow, the higher its P/E is likely to be. This is because investors are prepared to pay more for stock that promises high returns in the future.

However, P/E is probably most useful when compared with previous years in the same company, with other stocks in the same sector, and with industry averages. The ratio may vary widely within the same market, because not all companies engaged in the same kind of work will do it in the most efficient—and profitable—way.

What to Do

The formula for P/E is very straightforward:

P/E = price per share / annual earnings per share (EPS)

For example, if EPS for the last financial year is $8 and the stock price is $74, P/E is:

74 / 8 = 9.25

Effectively, this means that investors are prepared to buy shares that (at the current rate) will recoup their money in 9.25 years. P/E can also be calculated on the basis of forecast—rather than historical—EPS. So, using the same example, if analysts predict next year's EPS will be $10, the projected P/E is 7.4.

What You Need to Know

- P/E is used more than any other ratio for analyzing, comparing and selecting investments. However, the formula should be used with caution.
- High P/E stocks have frequently turned out to be poor investments in the long term, because the market wrongly predicted strong growth. Similarly, stocks with low P/E ratios in markets considered flat have proved the analysts wrong, and produced excellent returns.

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