The Price-to-Earnings Ratio

What is the P/E of a company?

The P/E ratio, also called the multiple, is the current market price of a stock divided by its earnings per share (EPS).

When investors use a company's P/E calculated by outside sources, they have to know how these sources calculated the figure. There are many definitions of this fundamental ratio.

- The *trailing P/E* divides the current price by the reported EPS from the latest fiscal year. This is the P/E found in the newspapers. *Yahoo! Finance* calculates the P/E by dividing the price by the sum of the Primary EPS from continuing operations *before* Extraordinary Items and Accounting Changes over the last four quarters, or "trailing twelve months (ttm)."

Although the trailing P/E is important, investors buy a company's stock based on the ***future*** *income stream of the company, not on what it has already earned!*

- The *forward P/E* uses **forecasted** EPS for the upcoming year.

This P/E makes more sense to use as an investor, but it is also riskier to use. Investors should remember that these are estimates, which a company can easily beat, or miss. Moreover, different Wall Street analysts will have different estimates. Therefore, the consensus estimated EPS would be an investor's most conservative route.

- The *current P/E* is the price of a stock divided by the sum of reported company earnings for the past six months and estimated earnings for the next six months.

This definition appears on Value Line's Web site, so if investors use Value Line, they should make sure they know which P/E they are using.

To avoid confusion with the varying definitions, investors should calculate their own P/E ratios.

Investors also need to assess if the P/E of a company is high or low. An investor should compare a firm's P/E with its competitors' P/Es and the P/Es of similar firms. It is important to know that the higher the P/E, the riskier it is to own the company's stock. Why? It is easier to miss expectations if projected earnings growth is very high.

- Stocks with high P/Es might not be overvalued. The high multiple may result from the industry in which the company participates. For example, technology stocks tend to have higher multiples than utility stocks.
- The age of the company also helps to determine the P/E of some stocks. Stocks with high P/Es tend to be young, faster growing companies. Mature industries, or industries in which earnings are stable, usually consist of stocks with lower P/Es.

It is important to calculate other financial ratios when investigating a firm. When looking at the P/E, investors should also consider the expected growth rate of the company they are analyzing.

- A simple rule is that a fairly-valued stock's P/E should equal the company's future growth rate.
- One useful ratio when looking at a company's multiple relative to its growth rate is the Price-to-Earnings-to-Growth ratio (PEG). This ratio can be found by taking the stock's P/E and dividing it by the future growth rate. When a stock is fairly valued, the PEG should be equal to one. Therefore, investors usually prefer to buy stocks that have a PEG below one.