ARVEST FUNDS AG

Monthly Report for June 2009

Fund manager's strategy report

The P/E ratio as a valuation benchmark and its pitfalls

The price-to-earnings (P/E) ratio is the relationship between the price of a stock and the profit earned by the firm. The P/E ratio is also used to evaluate the price of a stock. A stock with a low P/E ratio is classified as inexpensive, while a high-P/E stock is considered expensive. Due to the apparent simplicity and ease of understanding of the P/E calculation, investors are often all too quick to base their investment decisions on P/E alone. They overlook the fact that, despite the simplicity of the P/E calculation, its interpretation is somewhat more complex and all too often leads to faulty investment decisions.

Which profits should be used as the basis for calculating P/E?

The higher the profit, the lower the P/E ratio will be. While the price of the stock offers few options, the situation is not quite as clear in the case of profit. Should the calculation be based on the previous year's profit, profit in the last twelve months, the most recent quarterly profit (annualized) or estimated future profit? The type of profit chosen can greatly affect the resulting P/E ratio. Those who based their calculation of P/E in 2008 on profits from the previous year made the worst possible choice. Under this calculation method, which took into account the low stock prices of 2008 and the high profits of 2007, many stocks appeared extremely inexpensive. However, it was already clear at this point that profit levels seen in 2007 would be difficult to repeat in the near future.

The P/E ratio rises not only when stock prices rise, but also when stock prices remain the same and profit drops. Thus, in 2009, numerous stocks once again appeared expensive under this calculation method, which could have been interpreted as a signal to sell. To avoid misinterpretations, investors should always be aware of which profit was used to calculate P/E and whether the same level of profit can be realistically expected in the near future. I would like to reiterate here the skepticism of the ARVEST Investment Committee, particularly with regard to financial securities (see also my Monthly Report for May). Even under conditions as favorable as those in the past, financial firms may be forced to rely on profits instead of leverage to meet higher future capital requirements. This example shows that changes in government regulations alone are making future profit projections based on past earnings increasingly difficult.

Because the net profits of a company represent earnings less depreciation and reserves, companies are thus afforded a certain amount of leeway in determining their final profit. The options are utilized differently by different companies, making P/E comparisons difficult even among firms in the same sector. An alternative to profit is operating cash flow, in which the company's earnings are not influenced by the depreciation method selected.

How should P/E ratio be compared?

Key figures like the P/E ratio can be quite meaningful in relative comparison. Useful benchmarks can include the P/E ratio of other firms, the average P/E ratio of a peer group, average historical P/E ratios during the last decade or the interest rate plus a predetermined, company-specific risk premium. Without a comparative evaluation of the P/E ratio, its significance is greatly limited. The ARVEST Investment Committee firmly believes that the P/E ratio must be viewed in historical context. This means not simply comparing the current P/E ratio with that of previous years. Rather, it is important to compare P/E ratios from comparable time periods. If, as is frequently observed, the current P/E ratio during a recession is compared to the P/E ratio from a period of economic growth, the impression quickly arises that stocks are *cheap.* However, if the P/E ratio from the current recession is compared to the P/E ratio from a previous recession, the opposite impression may be given.

Conclusion

This short digression into P/E analysis confirms the expression taught to me recently by a Polish friend at an evening barbecue: "The deeper you are in the woods, the more trees there are." The P/E ratio, one of the most common key figures used by investors as a decision-making tool, reveals itself upon close examination as highly complex, its significance highly dependent on the context in which the figure is to be interpreted. A comprehensive analysis as part of the investment process is usually quite time-consuming. The past performance of ARVEST stock funds shows, however, that it is a worthwhile effort in the long run.

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