



Investor Info

Investment Commentary

Toxic P/E ratio

Is a share expensive or cheap? Anyone involved in share trading always asks himself this question in order to find the right time to buy and sell. This investment report addresses the question of how helpful the P/E ratio is in this connection.



Regular readers of the ARVEST investment report should remember that I had already addressed the P/E ratio¹ in June 2009. However, I would like to revisit this topic and go into more

detail, since this key ratio is revered by many investors. But at the same time it is more misunderstood than almost any other. If you are interested in this topic, you are cordially invited to attend my seminar on **2 February 2012²** at the **Swiss financial fair in Zurich**.

The main problem with the P/E ratio is that, at first glance, it works in a very understandable way. The P/E ratio is based on the correct assumption that there should be a relationship between the profit and the share price of a company. In most cases an increase in profits results in an increase in the share price, since the shareholder will benefit from this development in the future either directly through a higher dividend or indirectly, for example, through share buybacks.

¹ Price/earnings ratio

² Schweizer Finanzmesse, 13:00- 13:40 o'clock, Seezimmer 5

Estimated profits

The P/E ratio remains the same when the earnings of a company increase or decrease in the same proportion as the share price. However, as the future is mainly traded on the exchange, the share price adjusts in particular to the future expected earnings of a company, which can result in rising or falling P/E ratios. However, the problem with earnings estimates, or to be more exact with forecasts generally is that they relate to the future and are therefore uncertain.

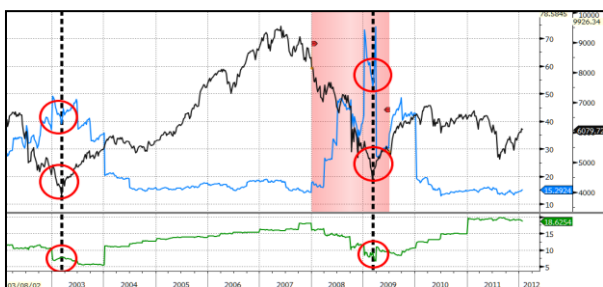
It is very often the case that analysts extrapolate past earnings and always assume an annual growth in earnings in periods of economic growth. This calculation based on estimated future instead of historical earnings leads to lower P/E ratios, which often leads to the purchase of a share.

The example of **UBS** shows how reliable earnings estimates made by analysts can be. At the end of 2006 many analysts gave their estimates of UBS profits for 2009. On average, earnings of about CHF 10 per share were forecasted. During 2007 these analysts then revised their estimates downwards to around CHF 7. In 2008 these were reduced even further to about CHF 2 due to the financial crisis. In retrospect, even this estimate of CHF 2 proved to be rather

optimistic. As is well known, UBS recorded a loss of billions in 2009 and the share itself was quoted in the same year at times below the CHF 10, which, a few years earlier, the analysts had forecasted (with the help of their complex models) as a profit.

Realized profits

However, using realized profits to calculate the P/E ratio is no less dangerous, mainly because the profits of many companies can fluctuate sharply during an economic cycle. A ratio such as the P/E ratio, where the figure used in the denominator (earnings) as well as the numerator (share price) fluctuate sharply, is hardly appropriate for an investment decision. On the contrary: the P/E ratio, when viewed uncritically, is in fact particularly well-suited for destroying wealth on a sustained basis, as it can prompt buy and sell decisions to be made at the worst moment. Let us look at the chart below with regard to this.



The chart shows the performance of the SMI³ (black line) and the price/earnings trend (blue line) over the last ten years. According to this, the best times to enter the market were March 2003 and March 2009 (black vertical lines). But it is at these exact points in time that the P/E ratio is exorbitantly high, namely over 40 in 2003 and even between 50 and 70 in 2009. Investors, who used the P/E ratio as their value barometer, almost certainly not only missed the ideal moment to enter the market but, in all likelihood, also sold other shares held in their securities accounts at that time.

³ Swiss Market Index, most important share index in Switzerland.

Profit margins

So why do P/E ratios behave in reality in exactly the opposite way to the heresy disseminated that shares with high P/Es are expensive? In order to answer this question we must look at the chart again. In the lower part of the chart (green line) one can see the profit margin trend of the companies included in the SMI. The chart shows that the profit margins have fluctuated between 6% and 18% over the last ten years. Profits generally decreased more sharply than sales especially in economic crises⁴, which resulted in declining profit margins. And it also now becomes clear how the high P/Es were able to arise in 2003 and 2009, namely as a result of profits of the companies decreasing significantly more sharply than the share prices themselves. However, this need not be the case in every crisis. It is also possible for share prices to fall more sharply than profits, which would result in lower P/Es.

The above comments illustrate that the P/E ratio viewed in isolation is completely useless. The P/E ratio could only be of any relevance on a multi-dimensional analysis of a company and its overall economic environment⁵.

However, the risks inherent in the misinterpretation of this ratio are so high that investors would be better off completely ignoring this simple variant of it. Yes, you have read correctly. Even if the P/E ratio has grown dear to you: **ignore it in the future.** Your securities account will thank you for it!

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⁴ Red area shows US recession.

⁵ Mainly for companies with a stable earnings trend.