



THE Adviser

Is The Market Over or Under Valued

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What is a P/e ratio and how is it worked out?

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How can we apply P/e ratios and what does it tell us?

A friend of mine, who isn't a financial adviser nor has he ever worked within the Financial Services industry, recently tried to give me some advice on investments, which I thought was novel. I waited with baited breath in anticipation of what he was about to say,

"I think Tobacco shares are looking expensive," he started.

I thought this was very insightful as I had been considering this thought myself.

"Why do you say that?" I queried.

"I was going to buy some British American Tobacco (BAT) shares but I didn't because they were £33.80 (quoted as 3,380p), that's just too dear for one share." My friend responded.

His initial statement may well be true but the reasoning to come to that conclusion is most certainly not.

When buying equity you are buying a share in a company. The market capitalisation of a company at any point in time can be calculated, which simply is:

$$\text{Market Capitalisation} = \text{Market Price} \times \text{Current number of shares}$$

So, if a company is worth £1 and there are 10 equally denominated shares, the share price will be 10p each. As a holder of all the shares in this company, you would be the 100% owner shareholder. If however there was only 1 share in this same company and those shares were 100p (£1), it would not make the company 10 times more valuable. The valuation of the company in financial terms would be exactly the same.

The price paid for a share and ignoring all other information available cannot infer value. We cannot deduce if something is cheap or expensive without taking account of other information.

One of **many ways** to assess the value of a share is by using a price-to-earnings ratio sometimes referred to as a P/E ratio. It is the way of valuing a share price relative to its annual earnings per share. It is calculated as follows

$$\text{P/E Ratio} = \frac{\text{Market Price Per Share}}{\text{Annual Earning Per Share}}$$

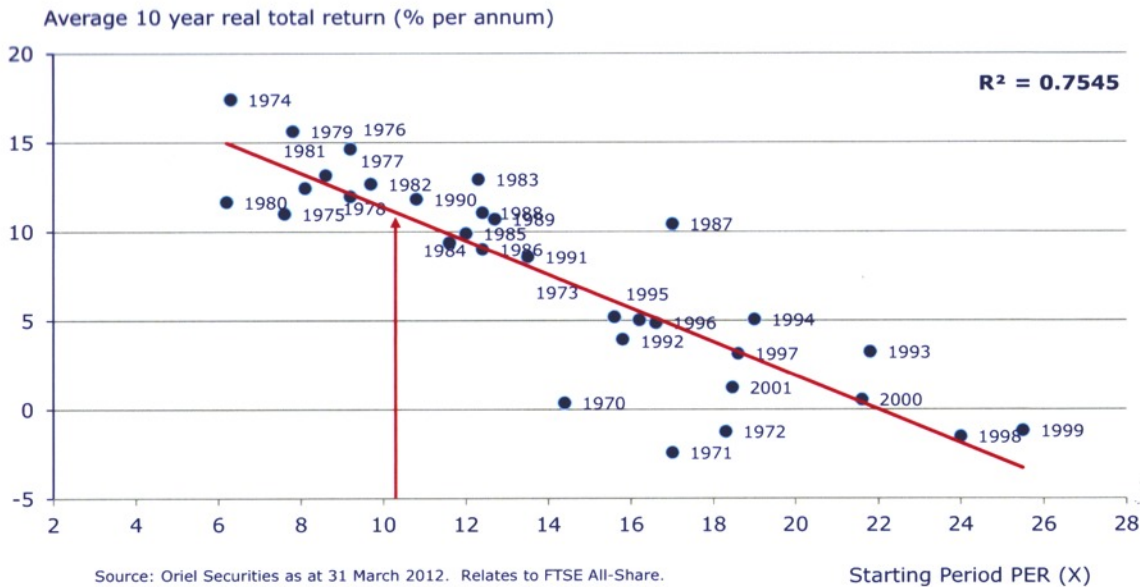
Its output tells you how long it will take to be paid back in earnings, for the price paid for your share in a particular company. For example; Stock A is trading at 30p and the earnings per share for the last 12 months have been 5p, then Stock A has a P/E ratio of 6. The purchaser of the shares is paying 6p for every penny of earnings.

Low P/E ratios	Can be considered as companies that are undervalued, but care needs to be taken that the company's earnings are not in decline, or that earnings are not subject to one off gains.
Medium P/E ratios	Could be considered as fair value based companies.
High P/E ratios	Could be considered as Growth companies where earnings are expected to be derived in the future. It could also be an indication that the company is overvalued.
Very high P/E ratios	Would generally indicate the company is subject to a bubble.

Continued

So far I have illustrated a P/E ratio in relation to an individual company, but it is also possible to look at the P/E ratio in relation to a sector or the market as a whole.

Starting valuation is key to future returns



The figures in the graph refer to past performance, which is not a reliable indicator of future results.

What the graph above is showing is the average 10 year real return that has been derived from a price earnings ratio at the start of that year.

So, if you had invested in 2001 with the P/E ratio just over 18, this would have led to a 1% per annum real return if you remained invested for the next 10 years. In 1998 and 1999 a P/E ratio over 24 led to real losses of -2% per annum for the next 10 years. Conversely, in 1974 a P/E ratio of 6 led to over 17% per annum real returns for the next 10 years.

At the moment the P/E ratio on the FTSE All-Share is 10.6%. This does not suggest it's the buy of the century nor does it reflect that you should stay away until the bubble bursts. What it is highlighting, very simply, the market is offering a very decent entry point for medium to long-term investors.

It is worth remembering that this is just a signal. It is not 100% full proof. If it was 100% full proof the statistical significance (r^2) would be 1 instead of 0.7545.

The value of your investment and any income from it may go down as well as up. You may not get back the original amount you invested. Tax treatment is dependent upon individual circumstances and may be subject to change in the future.