

What It's Worth

By Vincent Young

Have you ever stopped yourself from buying something because it was too expensive? If you have, what was it and why did you think its price was too high? If you haven't, think about something you bought or wanted to buy recently. Do you think its price is fair?

Valuation

In investing finding out what a stock is really worth or its "fair price" is called, "valuation." If a stock's price is much higher than its competitors, it may be described as **overvalued**. A stock with a price much lower than its competitors may be described as being **undervalued**.

P/E Ratio

A stock's **price-to-earnings ratio** or "P/E ratio" is one of the tools financial professionals use to figure out if a stock's price is fair, undervalued, or overvalued. P/E ratio is often explained as the amount of money investors are willing to pay for one dollar of a company's earnings.

To find a stock's P/E ratio divide its current stock price by its earnings per share. **Earnings per share** or "EPS" is a company's profit (the money it

earned) divided by its outstanding shares of stock. **"Outstanding shares"** refers the total number of the company's stocks held by individuals like you and me as well as businesses like banks and mutual fund companies.

Calculating P/E Ratio

$$\frac{\text{CURRENT STOCK PRICE}}{\text{ANNUAL EARNINGS PER SHARE}} = \text{P/E RATIO}$$

If a company's stock is currently \$30 a share and its EPS is \$2, its P/E ratio is 15. This means the stock is trading at 15 times its company's earnings. It also means that investors are willing to pay \$15 for \$1 of the company's earnings.

TTM & NTM

If you see the letters "TTM" next to a stock's P/E ratio or the word "trailing" in its description, it means the EPS being used to calculate it is the **"Trailing Twelve Month"** earnings per share. This is the money a company has earned in the last 12 consecutive months.

A trailing P/E ratio is a reliable measure of a stock's value because the earnings used to calculate it are actual numbers that can be checked and verified. Most financial news sites are referring to the trailing P/E ratio when they list a stock's P/E ratio in their stock quotes.

However, because a trailing P/E ratio is rooted in past performance and does not consider potential future earnings, financial professionals sometimes include a stock's forward P/E ratio in their search for a stock's value.

A **forward P/E** ratio uses a company's estimated earnings for the next 12 consecutive months to determine the value of its stock. It is sometimes identified with the initials, **"NTM"** (Next Twelve Months).

Financial professionals do not rely on just forward P/E ratios to figure out a stock's value because the

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earnings used to calculate it are estimates which can turn out to be lower than expected when the actual earnings become available.

PEG

A PEG ratio provides added insight to a stock’s value by including the company’s earning growth over a given period of time. PEG is an abbreviation for **“price-to-earnings-to-growth.”**

To find a stock’s PEG ratio, first calculate its P/E ratio and then divide it by its company’s expected earnings growth rate. The expected earnings growth rate can be calculated by finding a stock’s quarterly estimated EPS numbers. Subtract the first quarter’s estimated EPS from the current quarter’s EPS and then divided the result by the first quarter’s estimated EPS.

Calculating PEG Ratio

$$\frac{\text{P/E RATIO}}{\text{EARNINGS GROWTH RATE}} = \text{PEG RATIO}$$

If a company’s stock has a P/E ratio of 15 and an expected earnings growth rate of 20% over its next four quarters, it’s PEG would be 0.75. (Do not convert the growth rate from a percentage into a decimal. Simply divide 15 by 20.)

Top 10 Trailing P/E Ratios

Industry Name	Trailing PE	Forward PE	PEG Ratio
Food Wholesalers	8.64	20.39	0.71
Broadcasting	12.42	25.73	0.96
Air Transport	13.47	27.42	NA
Retail (Grocery and Food)	14.41	18.42	0.78
Electronics (Consumer & Office)	14.62	17.44	0.66
Bank (Money Center)	14.86	13.26	2.83
Reinsurance	15.20	12.99	0.51
Banks (Regional)	15.39	12.87	2.32
Real Estate (Development)	15.96	11.66	1.10
Chemical (Diversified)	17.19	12.78	2.35

SOURCE: Aswath Damodaran, NYU Stern School of Business (January 2021). http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/pedata.html

You might consider adding this company to your portfolio after doing more research on it. The general opinion is that a PEG ratio that is below 1 is a good investment. A PEG ratio over 1 is not as good.

whether or not a stock’s price is fair. Each of these ratios has its own limitations and can change without notice. They should be used as a part of your investment research but not the sole reason for your investment decision.

Final Evaluation

Most financial news and stock quote sites have already calculated a stock’s PEG ratio for you as well as its P/E ratio and forward P/E ratio. You may need to search the various sections of a stock quote to locate them.

All these numbers can also be hard to decipher without an experienced financial professional. Many investors rely on the expertise of their financial advisors to help them understand the often contradictory information available.

P/E ratios, forward P/E ratios, and PEG ratios are starting points to help you decide

TO THINK ABOUT

1. The forward P/E ratio and PEG ratio are not always immediately visible in a company’s stock quote. Visit your favorite stock research site and look up the quote for a company you would like to include in your SMG portfolio. Where is its Forward P/E ratio and PEG ratio information located? Under Statistics? Financials? On the main quote page?
2. Find the P/E ratio for one of the stocks in your portfolio. Compare it to the P/E ratios of three of its competitors. Is it higher, lower, or similar? Now, find the PEG ratios for all four stocks. How do their PEG ratios compare? Higher, lower, or similar? Would you invest in one of your company’s competitors instead buying additional shares? Explain.
3. Is a high P/E ratio a better investment than a low one? Is it the same for PEG ratios? Review the Top 10 Trailing P/E Ratios table above. Write three conclusions you can draw about the relationship between P/E ratios, Forward P/E ratios, and PEG ratio. Explain how you drew these conclusions.