



Horatio & the Ratio

by Bill Dickneider

Horatio has an unusual name. Some kids at school tease him about it. Others even have trouble pronouncing it. So Horatio was glad one day when he met someone who also has an unusual name. Well, maybe we really shouldn't call this someone a someone. You see, it really wasn't a person at all.

Eloquent Ink

It started one day when Horatio was writing an essay about the stock market for a class contest. He concluded the essay with the following sentence: "Reebok's stock price is higher than Skechers', so Reebok's stock is more expensive." Then he signed his name, set the pen down and stared at his name on the essay. "Horatio is sure a different name," he said aloud to himself. "I can't even think of a word that rhymes with it."

"I can," said a squeaky voice that startled Horatio. There was the pen he had just used, standing upright and blinking at him.

"My name is P.E. Ratio," said the pen. "An unusual name, I agree. But Ratio does rhyme with Horatio, don't you think?"

"Well, sure," said a bewildered Horatio. "You're not one of those new digital talking pens I've heard about, are you?"

"No, I'm here to help you right what's wrong."

"Why would I want to write something that's wrong?" asked Horatio.

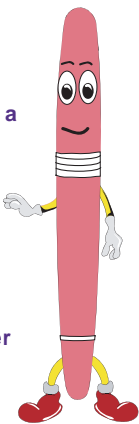
"No, I mean r-i-g-h-t, not w-r-i-t-e. You've written something that's wrong. I want to help you right it."

"What wrong did I write?" asked Horatio.

"You said Reebok's stock is more expensive than Skechers' because its price is higher," answered the pen. "But you can't tell which is more expensive by looking only at the stocks' prices. You have to compare their price/earnings ratios."

"What are they?" asked Horatio.

A stock has a price of \$40 and a price/earnings ratio of 20. What is the stock's earnings per share?



"I'm an expert in the subject, which is how I got my name, P.E. Ratio. But you can just call me P.E. Let me give you a simple example," continued P.E., while writing out the following numbers. "Let's call one company Pen and the other Pencil."

	Pen	Pencil
A. Stock's Price	\$20	\$15
B. Company's earnings, last 12 months	\$10,000	\$4,000
C. Shares owned by stockholders	10,000	8,000
D. Earnings per share (= B/C)	\$1.00	\$0.50
Price/Earnings Ratio (= A/D)	20	30

"The price of Pen's stock is higher than Pencil's," said Horatio. "So isn't Pen's stock more expensive?"

"Not necessarily," answered P.E. "I'll show you why, but first tell me how much Pen earned during the last 12 months."

"Ten thousand dollars," answered Horatio.

"And how many shares of Pen's stock did stockholders own?"

"Ten thousand shares."

"Right," said P.E. "If you divide the company's total earnings of \$10,000 by the 10,000 shares stockholders own, you get \$1.00. That's the stock's **earnings per share**. This is the amount of Pen's current earnings that would belong to you if you buy one of its shares."

What about the company's price/earnings ratio?" asked Horatio.

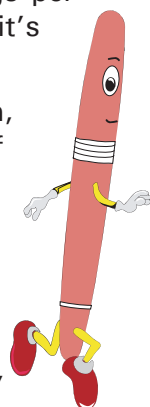
"Divide the stock's price of \$20 by its earnings per share of \$1.00," said P.E. "You end up with 20. That's its **price/earnings ratio**, or **P/E ratio** for short."

"So it's really a fraction," said Horatio. "The stock's price is on the top, and earnings per share is on the bottom. I wonder why it's not called the price/earnings *fraction*."

"Then my name would be P.E. Fraction, and I don't much care for the sound of that. Besides, a ratio really is the same thing as a fraction."

"What does the ratio tell me about a stock?" asked Horatio.

"It shows how much you'd pay for a dollar's worth of a company's earnings."



"How does it show that?" asked Horatio.

"Well, Pen's P/E ratio is 20 because a share that costs \$20 gives you ownership of \$1 worth of the company's current earnings. It works the same way with Pencil's stock. Its P/E ratio is 30 because you'd have to spend \$30 to own a dollar's worth of its earnings. You could do that if you buy 2 shares at \$15 each.

"So by comparing their P/E ratios, I'll know which stock has a lower cost for a dollar's worth of earnings," concluded Horatio. "A dollar's worth of earnings would cost \$30 with Pencil's stock and \$20 with Pen's stock.

"That's right," agreed P.E. "So which stock is more expensive?"

"It sounds weird, but Pen's higher-priced stock is really less expensive when you consider what you're paying for current earnings."

"Let's walk through an example using the two shoe companies in your essay," said P.E., while writing out the following:

	Reebok	Skechers
Stock's price	\$42	\$14
Price/earnings ratio	15	66

"According to your essay, Reebok's stock is more expensive than Skechers' because its price is higher. But is Reebok's stock really more expensive when you consider what you're paying for its earnings?"

"I guess not," answered Horatio. "Reebok has a higher stock price, but its P/E ratio is lower. So a dollar's worth of its earnings is less expensive than a dollar's worth of Skechers' earnings. I'd better revise my essay before I turn it in."

Write Now

Pick one of the following and write a paragraph to explain your answer.

Use a newspaper or the Web to find the latest stock prices and P/E ratios for Skechers, Reebok, Timberland, and Nike. Which stock do you think is most expensive? Least expensive?

Many companies have no earnings at all. Would they have price/earnings ratios?