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ABREAST OF THE MARKET | AUGUST 30, 2010

The Decline of the P/E Ratio

By BEN LEVISOHN

As investors fixate on the global forces whipsawing the markets, one fundamental measure of stock-market value, the price/earnings ratio, is shrinking in size and importance.

And the diminution might not stop for a while.

The P/E ratio, thrust into prominence during the 1930s by value investors Benjamin Graham and David Dodd, measures the amount of money investors are paying for a company's earnings. Typically, companies that post strong earnings growth enjoy richer stock prices and fatter P/E ratios than those that don't.

But while U.S. companies announced record profits during the second quarter, and beat forecasts by a comfortable 10% margin, on average, the stock market has dropped 5% this month.

The stock market's average price/earnings ratio, meanwhile, is in free fall, having plunged about 36% during the past year, the largest 12-month decline since 2003. It now stands at about 14.9, compared with 23.1 last September, based on trailing 12-month earnings results. Based on profit expectations over the next 12 months, the P/E ratio has fallen to 12.2 from about 14.5 in May.



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Bloomberg News

The P/E ratio may not be vital anymore to investors or traders like Robert Gross, on the floor of the New York Stock Exchange on Aug. 11.

profits 18% in 2011. Now, they predict 15%. Mutual-fund, hedge-fund and other money managers put the increase at closer to 9%, according to a recent Citigroup survey, while Mr. Levkovich's estimate is for 7% growth.

"The sustainability of earnings is in doubt," said Howard Silverblatt, an index analyst at S&P in New York. "Estimates are still optimistic."

So what explains the contraction? In short, economic uncertainty. A steady procession of bad news, from the European financial crisis to fears of deflation in the U.S., has prompted analysts to cut profit forecasts for 2011.

"The market is worrying not just about a slowdown, but worse," said Tobias Levkovich, chief U.S. equity strategist at Citigroup Global Markets in New York. "People want clarity before they make a decision with their money."

Three months ago, analysts expected the companies in the Standard & Poor's 500-stock index to boost

Equally troublesome, analysts' forecasts are becoming scattered. In May, the range between the highest and lowest analyst forecasts of S&P 500 earnings per share in 2011 was \$12. Morgan Stanley predicted \$85 per share, while UBS predicted \$97 per share. Now, the spread is \$15. Barclays said \$80 per share; Deutsche Bank predicts \$95.

When profit forecasts are tightly clustered, it signals to investors that there is consensus among prognosticators; when they diverge wildly, it shows a lack of clarity. The P/E ratio tends to fall as uncertainty rises, and vice versa.

"A stock is worth its future earnings, but that involves uncertainty," said [Jeremy Siegel](#), professor of finance at the University of Pennsylvania's Wharton School. "The more uncertainty there is, the lower the P/E will be."

Not only is the P/E ratio dropping, it also is in danger of losing some of its prominence as a market gauge.

That is because, with profit and economic forecasts becoming less reliable, investors are focusing more on global economic events as they make trading decisions, parsing everything from Japanese government-debt statistics to shipping patterns in the Baltic region.

To some extent this is in keeping with historical patterns. P/E ratios often shrink in size and significance during periods of uncertainty as investors focus on broader economic themes.

P/E ratios fell sharply during the Depression of the 1930s and again after World War II, bottoming at 5.90 in 1949. They plunged again during the 1970s, touching 6.97 in 1974 and 6.68 in 1980. During those periods, global events sometimes took precedence over company-specific valuation considerations in the minds of investors.

There have been periods when the P/E ratio was much more in vogue. A century ago, the buying and selling of stocks was widely considered to be a form of gambling. P/E ratios came about as a way to quantify the true value of a company's shares. The creation of the Securities and Exchange Commission during the 1930s made financial information more available to investors, and P/E ratios gained widespread acceptance in the decades that followed.

But thanks to the recent shift toward rapid-fire stock trading, the P/E ratio may be losing its relevance. The emergence of exchange-traded funds in the past 10 years has allowed investors to make broad bets on entire baskets of stocks. And the ascendance of computer-driven trading is making macroeconomic data and trading patterns more important drivers of market action than fundamental analysis of individual companies, even during periods of relative calm.

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So where is the P/E ratio headed in the short term? A few optimists think it could rise from here. If corporate borrowing costs remain at record lows and stock prices remain depressed, companies will start issuing debt to buy back shares, said David Bianco, chief U.S. equity strategist for Bank of America Merrill Lynch. As a result, earnings per share would increase, he said, even if profit growth remains sluggish, and P/E ratios could jump with them.

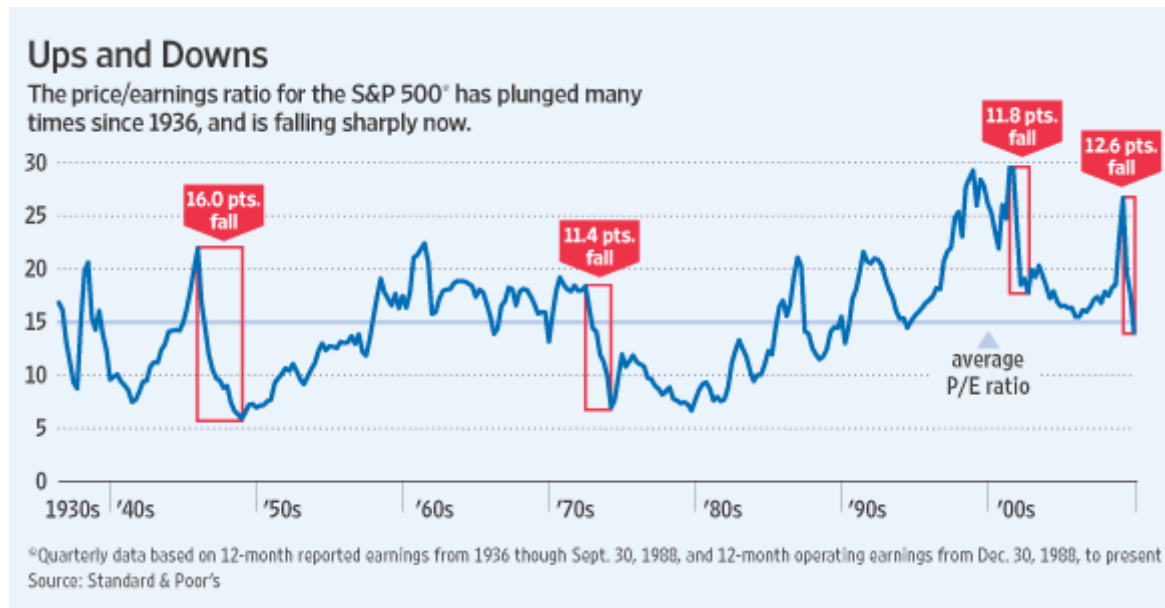
But today's economic uncertainty argues against that scenario. Consider that while P/E ratios dropped during the inflationary 1970s, they also fell during the deflationary 1930s. The one common

People may be relying on P/E ratios less these days, but they will maintain their relevance in the end. The current drop in market P/E will simply create new opportunities for the savvy (and courageous) investor in the years to come.

thread tying those two eras of falling P/E ratios: unpredictable economic performance.

"We're looking at a more volatile U.S. economy than we experienced in the last 30 years," said Doug Cliggott, U.S. equity strategist at Credit Suisse in Boston. "The pressure on multiples may be with us for quite some time."

—Patrick Balester



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