Financial Tailor

August 12th, 2013

How to get an ‘A’ in PE.

Author: Benjamin Struck

President

Last week stocks fell, ending several weeks of positive momentum despite relatively good economic news. However, many have speculated that, in the short term, good news is bad news because it might mean that the Fed could reduce its purchases of treasuries and mortgage backed securities. The housing sector remained strong as the existing home supply dropped to 5.1 months of supply in the second quarter down from 6.4 months in the second quarter of 2012. Mortgage delinquencies were also down and Fannie Mae and Freddie Mac were able to return $10.1 billion and $5 billion respectively to the treasury.

S&P 500 Index

-14.06 **-0.82%**

Dow Jones Industrial Average

-187.92 **-1.20%**

NASDAQ Composite

-23.31 **-0.63%**

Last week I wrote a simple introduction to income statement analysis. This week's newsletter will build on last week's analysis. There are many common ratios that are derived from the income statement that will help provide a better understanding of an individual company's value.

PE Ratio = Current Price ÷ Earnings Per Share

Ex.

Company ABC is trading at a price of $50 per share. Over the last year, ABC has earned $5 per share.

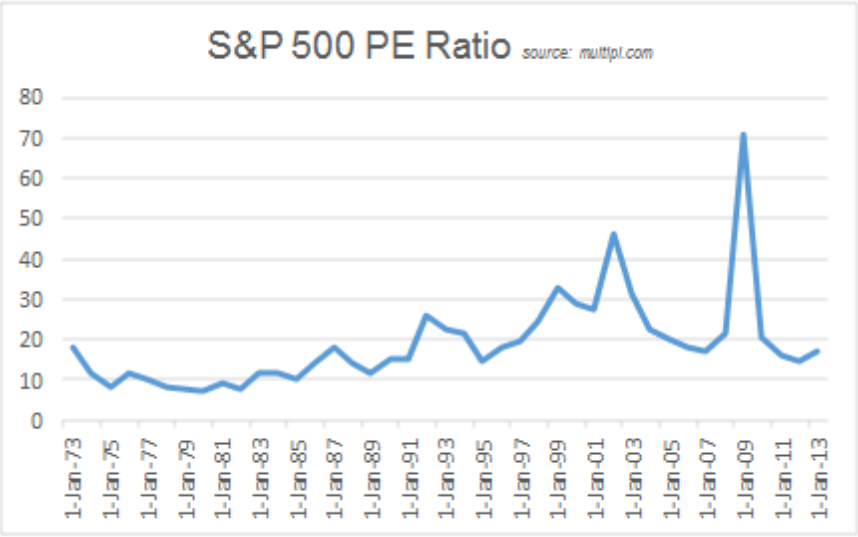
EPS = $5, Price = $50

PE ratio = Price ÷ EPS = $50 ÷ $5

PE ratio = 10

How to get an 'A' in PE

One of the most common ratios that investors use to value a company is the price-to-earnings ratio or PE ratio. Last week we showed how to find a company's earnings-per-share (EPS). The formula on the right shows how to calculate the PE ratio from a company using its EPS. The example shows a company with a PE ratio of 10; you may also hear the media say that it trades at 10 times earnings. The current PE ratio of the S&P 500 is about 19.2.



A high PE ratio tells you that the market expects this particular type of company to grow rapidly, while a low PE ratio usually means that the market expects low growth. As a result, internet companies tend to have higher PE ratios than railroad companies. However, a high PE ratio can also mean that a company is overvalued. During the Tech bubble, PE ratios were extremely high for a number of new

internet companies, but once it became apparent that those companies could never grow their earnings at that rate, they quickly lost their value.

The chart on the right shows Amazon's stock price during the tech bubble. Optimism for a company's long term prospects can often manifest itself to an irrational degree in the near term. During the tech bubble, it was not uncommon for companies with untested business models to have a PE over 100 based on the hope that they would become the next big thing.

Sometimes a high PE ratio is completely justifiable. Take our example on the previous page. Imagine that ABC company was expected to sign a huge contract that would double their earnings. You would likely see the stock surge to a much higher price and thus raise its PE ratio to reflect the upcoming change. As a result, many investors will look at the forward PE ratio of a company instead. The forward PE ratio is the expected PE ratio of the company based on expected earnings over the next 12 months.

Return on Equity

Another great metric to look at is return on equity. The formula is on the right. Return on equity is useful because it tells you how much money the company makes with the money that shareholders have provided. While a stock's price is not necessarily a function of its profitability, a company's return on equity is. I prefer to think of return on equity as a company's efficiency. For every dollar that an investor gives to this company, how much profit does it generate. Let's look at two real world examples.

Apple is great at generating profits. It has a return on equity of 32.11. The popular social networking site Linkedin has a return on equity of 4.24. Clearly Apple is more efficient at generating profits than Linkedin, but now let's look at the PE ratio. Apple has a PE ratio of 11.50 while Linkedin has a PE ratio of 898.33. Linkedin is an extremely fast growing company, and as result, the market expects it to continue growing at a much faster pace, while the market expects Apple to lose profitability because of increase competition. Apple's stock has plunged while Linkedin's stock price has soared. However, if Apple were to show signs of growth or if its growth is less affected than the market predicts, Apple's stock will surge. On the flipside, if Linkedin shows signs of slowing growth its stock price could plunge.

Return on Equity = Net Income ÷ Shareholder Equity

Conclusion

Using metrics can be useful in determining the intrinsic value of a company. However, these metrics can confound investors who look for immediate gratification. Stocks tend to rise slowly and fall suddenly. So value investors who buy profitable companies that have fallen out of favor with the market may have to wait a long period of time before their stock picks will pan out.

Strategic Allocation

Conservative  Aggressive

RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Neutral short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Neutral intermediate term debt

Neutral Long Term Debt, this asset class has been oversold as a result of market expectations of Fed tightening, we are slowly purchasing more long dated treasuries and TIPS at the higher yields.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Neutral Small Capitalization Stocks, we are recommending smaller companies with strong balance sheets and little need for short term debt financing.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Underweight Large Cap Stocks, We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will start looking to slowly increase REIT holdings now that selling has begun.

Overweight Commodities, we believe that we are now in a period of deflation, and that the selloff in commodities is largely tied to China. This selloff is likely overdone especially with respect to precious metals. We are bearish on oil prices long term.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen.