VALUE SERIES I:

USING THE P/E RATIO TO FIND "CHEAP" ASSETS

THE RETIREMENT GROUP LLC
PARTNERS IN RETIREMENT

TABLE OF CONTENTS

1 The Value Series

2 The P/E Ratio

4 Performance

7 Conclusion

8 Sources

THE VALUE SERIES

Given current market volatility, we think now is a good time to revisit important value metrics in our four part series. In the first part of this value series we will look at the Price-to-Earnings ratio.

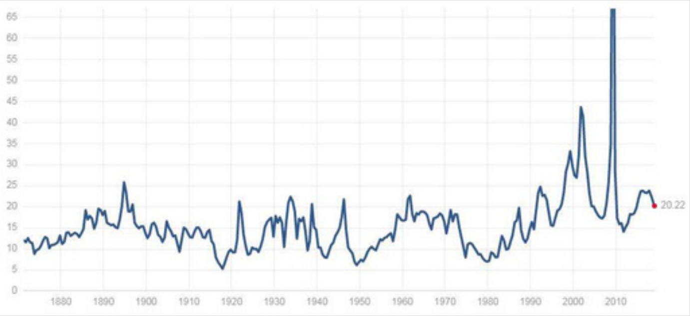
Investors are often trying to find ways to beat the market. If you're one of those investors, you should consider the following proven strategy that has been implemented by some great investors. Value investors figured out how to beat the average annualized returns of the S&P 500 a long time ago, and many have successful track records spanning several decades to prove it. Warren Buffett is certainly the most famous value investor, but there are many others, including Benjamin Graham, David Dodd, Charlie Munger, Christopher Browne and Seth Klarman.

This investment style focuses on four metrics that characterize a value investment. These four metrics include the Price-to-Earnings Ratio, the Price-to-Cash Flow Ratio, High Dividend Yield and the Price-to-Book Ratio. These metrics, as you will see, are strong indicators of an undervalued security. These undervalued securities consistently outperform the market. We will examine the effect of investing based off of certain characteristics and how their investment returns are correlated.

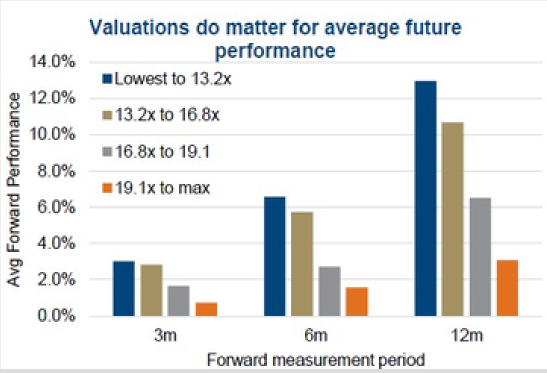
The P/E Ratio

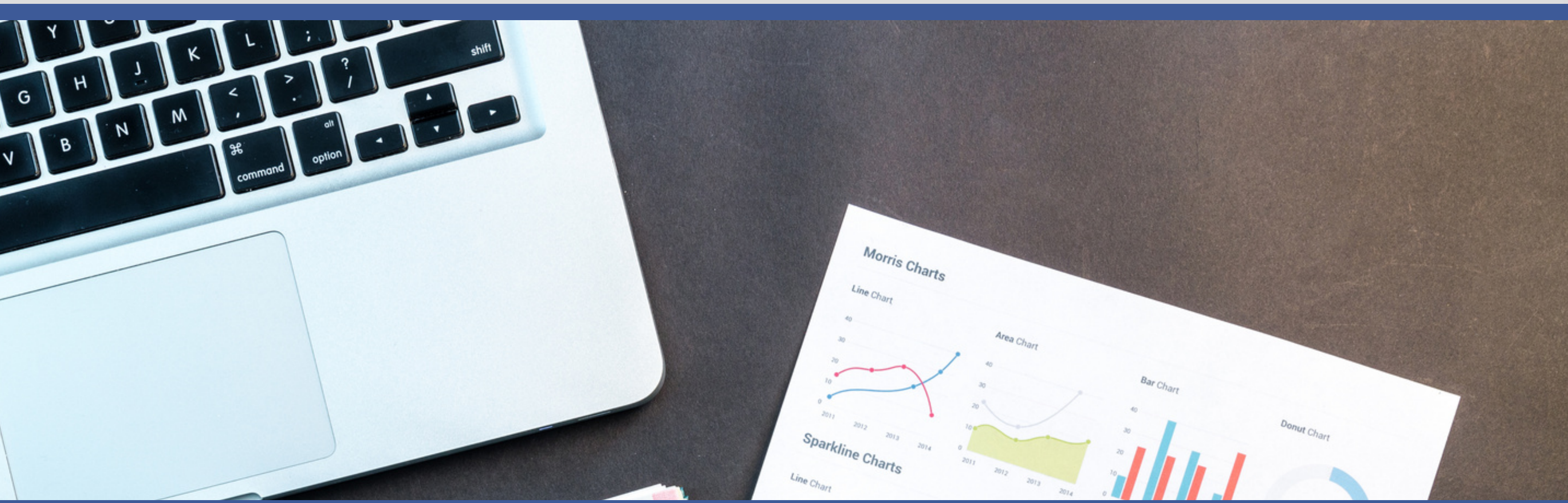
The price-to-earnings (P/E) ratio is a remarkably indicative fundamental ratio of future performance, yet it is often ignored or dismissed. Currently the S&P 500 is at a P/E ratio of 40.13, well above its longtime average of 15.91.

The P/E ratio is a valuation ratio for a company that measures its current share price relative to its earnings-per-share (EPS). The P/E ratio can be calculated as: Market Value-per-Share/Earnings-per-Share. The P/E ratio indicates the price an investor is willing to pay for each dollar of net earnings for the company. For instance, if a company had a share price of $20 and its EPS is $2 then the P/E ratio is 10. A stock that trades at a low P/E is generally considered “cheap”, while a stock with a high P/E indicates a more expensive stock as investors might expect more growth.



With a volatile market, it is understandable to wonder how the market is going to perform moving forward. When comparing historical P/E ratios with short-term future performance it is still apparent that “cheaper” stocks outperform (shown to the right). In addition to higher average performance, it was found that (when looking out one year) the market was higher 77% of the time if the P/E ratio was below 13.2 as compared to 58% of the time when the P/E ratio was over 19.1.



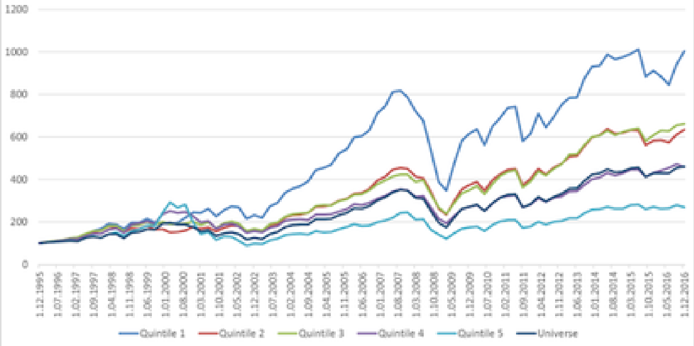


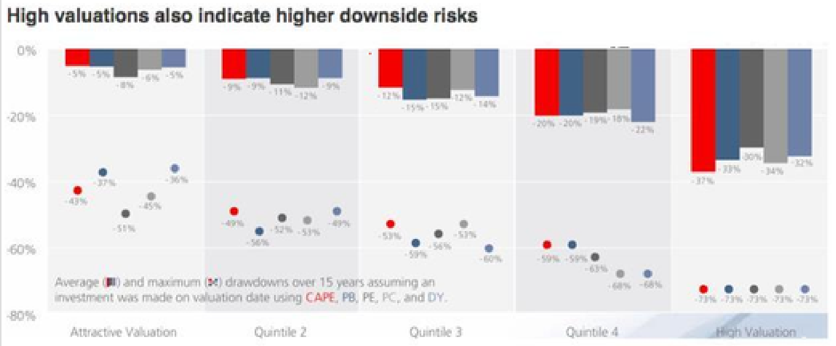
PERFORMANCE

In a study by Quantitative Alpha, they analyzed the performance of the 1000 largest global companies (by market cap) by sorting them into quintiles based on price-to-earnings ratios. Stocks with negative earnings were excluded. They examined the returns of the five equal portfolios consisting of 200 stocks each over a twenty-one year period, from December 31, 1995 to December 31, 2016 with the portfolios rebalanced quarterly. Their results are shown in the charts below and on the next page.

PERFORMANCE

In their study, they found that the quintile of lowest P/E stocks significantly outperformed the high P/E quintile. The portfolio containing the lowest P/E stock returned 11.61% annualized compared to 4.83% for the highest P/E portfolio and 7.55% for the used universe of stocks. The graph below shows how the cumulative returns compare (it's not even close).





In a study over a longer time-period, screening for low P/E stocks has been shown to have less downside risk than high P/E stocks. In a backtest from 1979 to 2015 (and shown in the chart below), it was found that attractive valuations were followed by lower price declines than high valuations.

For every valuation metric under consideration, the chart shows the maximum losses investors could have suffered if they had sold at the worst point in time following a certain valuation level. Under these circumstances, the downside risk increases with rising valuation levels.

CONCLUSION

As can be seen in these studies, it is apparent that by simply screening for low P/E ratio stocks with no fundamental analysis, it is possible to outperform not only glamour stocks but the market as well. Not only that, but by choosing stocks with a low P/E ratio, it is possible to reduce downside risk over a long time period. Reinforcing this metric are the value oriented track records of notable names such as Warren Buffet, Bruce Berkowitz and Seth Klarman who all use the P/E ratio as a key indicator for their investment universe. Over the long run, the low P/E ratio acts as a strong indicator of a value investment. Over the long run, these "cheap" stocks tend to outperform and have less downside than more expensive stocks.

SOURCES

1] Basinger, Craig. “Do Valuations Matter”. http://www.valuewalk.com/2017/05/do-valuations-matter/

[2] Brandes Research Institute. “Value vs. Glamour: A Global Phenomenon”

[3] Carlisle, Tobias. “Investing Using the Price-to-Earnings Ratio and Earnings Yield (Backtests 1951 to 2013)”

[4] Cretcher, David. “Stocks are Overvalued – So what?”. Seeking Alpha. <https://seekingalpha.com/article/4063604-stocks-overvalued>

[5] Dreman Value Management LLC. “The Potential Advantages of a Contrarian Strategy”

[6] Tweedy Browne Company LLC. “What Has Worked in Investing: Studies of Investment Approaches and Characteristics Associated with Exceptional Returns”

For more Financial Information check out these resources!