Back to Contents

Published in *Eureka Report* on October 28

ValueLine: Why I ignore P/Es

By Roger Montgomery

PORTFOLIO POINT: I regard P/Es as nonsense, and forward P/Es, sector average P/Es and the like as nonsense squared.

I only look at stocks occasionally after they have been purchased. This provides me with advantages over those who might equate activity with performance.

Remembering that the tortoise won because the hare ran out of puff, I replaced the frenetic activity of my youth with a much more considered and disciplined approach that produces superior returns.

The returns, this year, of the stocks selected by the ValueLine portfolio are no exception. To the managers of these superior businesses, thank you.

But while I approach stock selection earnestly, there are times where a reassessment of my approach is necessary. With market prices for some of the stocks in my portfolio looking ridiculously expensive, this is one of those times and so, I turn my attention away from top-dressing the lawn to the matter of markets.

Despite the hopes and dreams of many Australians, the US market will remain the dog that wags the All Ordinaries tail for some time and so I offer my insights into the market value of the US.

If you don't already know, I have no use for price/earnings (P/E) multiples. Let me explain.

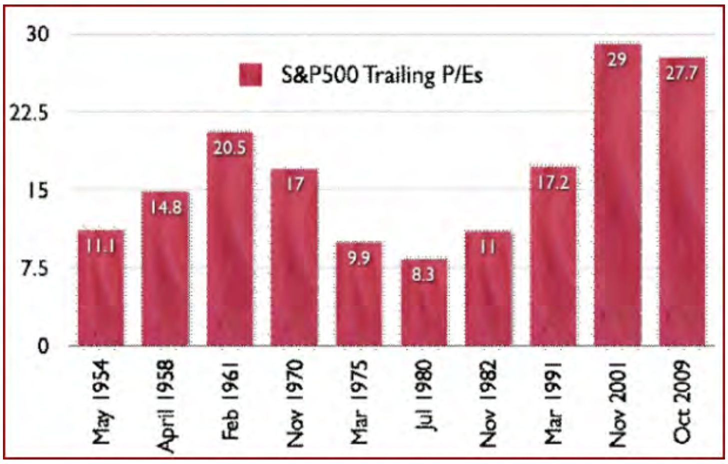
Suppose three companies each have $10 of equity per share, each returns 20% on that equity, and each is trading on a P/E of 10, which equates to $20. The only difference is that the first company is paying out 100% of its earnings as a dividend, the second is paying out 50% and the third pays no dividends.

If you were to assume that you could buy and sell the shares at the same P/E of 10, the first company would return 10% per annum over any number of years, the second would return 15% and the third 20%. The third is clearly the cheapest and yet all three had the same P/E of 10. P/Es can't tell you very much about value.

There are, however, times when P/Es are at such extremes that they provide support to my preferred analysis of the spread between price and intrinsic value. This is one of those occasions and so, without recognising the validity of P/Es, I will provide you with the fix that you need.

By definition, if the US economy is recovering, then we recently experienced the last month of the US recession. It would be worthwhile examining the P/E for the S&P 500 index on the previous occasions that represented the last month of a recession. Thankfully there are several sources that provide this information at the click of a mouse.

Let me start by noting that currently, the trailing P/E is 27. This seems extreme, and out of nine recessions since 1954 it is the highest trailing P/E at the last month of a recession with the exception of November 2001. The other eight observations ranged from a trailing P/E of 8.3 in July 1980 to 17.2 in March 1991. See the chart. Now some of the years in which the P/Es are very low, were also years of very high inflation. But even if those years are removed, today's trailing P/E is comparatively high.



Many readers will correctly point out that it makes no sense to use trailing P/Es if we are coming out of a recession because the trailing "E" is unusually low. In such situations, analysts focus on forward P/Es.

Of course you know my view: if P/Es are nonsense, then forward P/Es, sector average P/Es and the like are simply nonsense squared.

Nevertheless, on one-year forward estimates, the P/E ratio is at 16. This is the highest it has been since 2003. Even at the peak of October 2007, the forward P/E was about 14 and the highest it has ever been is 15.4 times.

But while it seems that multiples have, in six months, surged from historic lows to all-time highs, and while conventional wisdom would suggest that P/Es are at levels normally reserved for the late stages of a bull market, there is a counter-argument.

At market peaks such as October 2007, analysts are unusually bullish about the future, while after a recession, Back to Contents

The ValueLine portfolio, as at October 27, 2009										
Company	Buy price	Today	Est value	Margin of safety	No bought	Invested ($)	Cap value ($)	Divs rec	Total return	Total return
JB Hi-Fi	14.8	21.53	21.7	0.8%	845	$12,500	$18,184	0.29	$5,929	47.43%
Cochlear	56.36	64.55	58.7	-10.0%	102	$5,744	$6,579	0.95	$932	16.22%
CSL	31.81	31.45	28.99	-8.5%	163	$5,197	$5,139	0.4	$7	0.13%
Woolworths	26.16	28.92	26.7	-8.3%	206	$5,377	$5,945	0.56	$682	12.69%
Reece	17.8	24.8	13.7	-81.0%	236	$4,209	$5,865	0.33	$1,733	41.18%
Platinum Asset Mgt	4.06	5.85	2.84	-106.0%	854	$3,467	$4,995	0.12	$1,631	47.04%
CommBank	46.51	53.53	51.36	-4.2%	215	$10,000	$11,509	0	$1,509	15.09%
Since July 1										
Security Value										**$58,215**
Cash Value										$56,635
Total Value										**$114,850**
Total Return ($)										$14,850.12
Return Invested (%)										30.77%
Total Return (%)										14.85%
XAO Change										19.10%
Outperformance (I) of invested portion										11.67%
Outperformance (T) of total portfolio										-4.25%
Under observation										
Company	July 1 price	Today	Est value	Margin of safety				Divs rec		Total return
ISOFT	0.635	0.83	0.19	-336.8%						-30.71%
Amcor	4.79	5.68	2.84	-100.0%						-18.58%

analysts will be overly cautious about their forecasts. The result is low relative forward P/Es at peaks and apparently high trailing P/Es coming out of a recession.

Confused? I am. That's why I don't use P/Es, which try to predict what the predictors will predict.

What do I really think? I think the stockmarket has got ahead of itself and the high-quality businesses that I look at are now trading above their current valuations and are trading at their valuations two years out. US inflation at this stage does not appear to be a threat.

To illustrate, Target and Wal-Mart have started their sales early and that sounds like deflation to me. In the US, rent, restaurant prices, airfares and the prices for personal care products, education, household appliances and tools, hardware and outdoor equipment, confectionery and softdrinks are all plunging.

This, on top of the fact that the Federal Reserve's Beige Book has indicated that consumer spending remains weak, as does residential construction, architectural billings and commercial construction activity, suggests that the market has cast its shadow too far forward.

In time, you will of course discover that P/Es have no predictive power at all. This could be a bear market rally or it could very well be the first leg of a multi-year bull market. I don't have a particular view about that.

If, as the market climbs, you see managers who pay lip service to Warren Buffett and other value-investing luminaries lower their standards, it's time to be on red alert. They will start to talk publicly about smaller companies, higher-risk propositions and companies without identifiable competitive advantages or high levels of debt. They will try and find value where there is none.

It is important to look out for such compromises because it is itself a sign of excessive risk-taking.

My own valuations suggest that the easy money has been made. When share prices are well in excess of valuations, it is time to review your portfolio.

The Valueline portfolio has plenty of cash so any weakness, if it eventuates, will be an opportunity to add to the Buffett-style model.

So it's steady as she goes and we'll leave the predicting to those with crystal balls and P/Es. ◆

Roger Montgomery is an independent analyst and managing director at rogermontgomery.com.