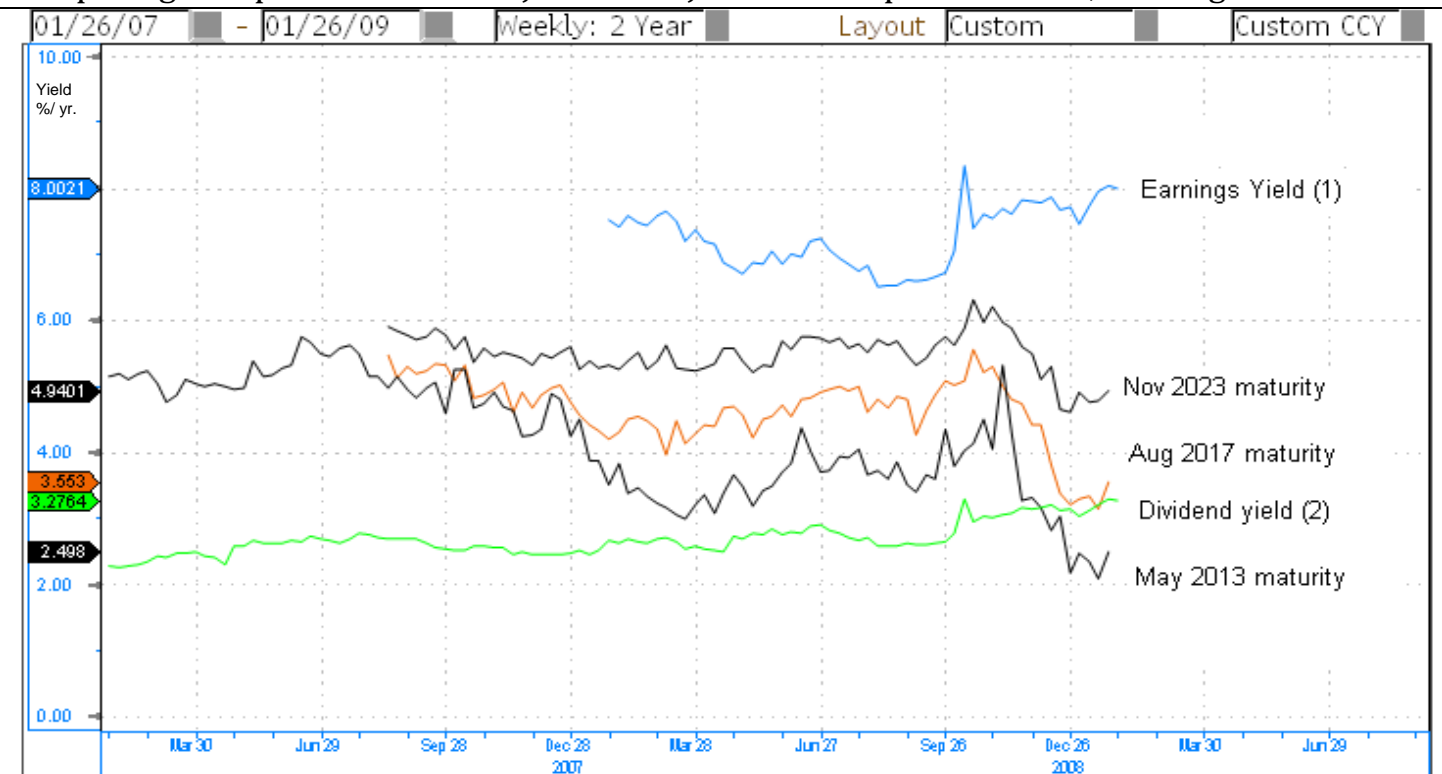


What is the Price/Earnings Multiple and Why is it Important?

- Amid a constant barrage of financial information, the humble Price/Earnings multiple is easy to find and just as easy to calculate, but often, its importance is overlooked or just plain misunderstood. In the current market, we continue to favor steady growth companies with high quality balance sheets. We believe their above-average P/E multiples are justifiable given their low risk, and they are very attractive compared to bonds ... including their own.
- Most investors are accustomed to basic measures of stock market valuation such as dividend yield and Price/Earnings (P/E) multiple; those that are not are heartily encouraged to do so. While The Wall Street Journal is no longer including these figures in its daily stock tables, you can still find them in Barron's and Investor's Business Daily. Besides, there are many easy-to-find sites on the Internet that provide them, too, along with a number of other statistics. But none of these are as simple or as widely available as the P/E multiple.
- Investors have been computing the prospective "cash return" (dividend yield) of their equity investments for many decades. The formula is simple: divide the current stock price into the annual dividend payment to compute a "return" (or yield) that is comparable with other prospective returns in the markets — such as those available on bonds or certificates of deposit .
- Take care when calculating yields and performing comparisons, because — as recent markets have taught us all too well — nothing is certain and everything is subject to change. Dividends may be reduced or eliminated without prior notice, and sometimes even bond coupons and principal payments are interrupted by default. These caveats are even more important when comparing a company's earnings with its stock price, given the sensitivity of earnings to the economic climate. The profit trend is a critical early warning system for investors; usually, trouble appears on the earnings front months or even years before there is a dividend cut or default.
- According to convention, the P/E multiple is computed by dividing the earnings into the price, but a more useful approach is to compute the "earnings yield" in the same way as the dividend yield, by dividing the price into the annual earnings amount. The result is easily compared to most other investments quoted on the same basis.
- Some traditions die hard. Given that the hand-held electronic calculator has been on the scene for nearly forty years, it is a mystery why the P/E multiple survives in its current form. Anyone still familiar with high school mathematics can see that P/E is not a linear function with respect to a change in earnings, and it gives wacky results when earnings are small or negative. These shortcomings are rectified by use of the earnings yield.
- Bond investors know that yield and price are inversely related; so, too, should stock investors realize that earnings yield and P/E are related in the same way. You can think of the P/E as the "price" of the earnings stream. Let's say your cousin in Germany asked you to become his partner in a successful brewing business, and after extensive study, you are convinced your investment would grow steadily at an attractive rate. But what about the currency? You need to buy euros to invest in the business, and the exchange rate will affect your returns.

You might think of the exchange rate as part of the price of investing in the earnings of the brewing business. Hopefully, the euro will appreciate and add to your return, though it may do just the opposite. But if it were a mediocre business, it would probably be a mistake to invest simply because you are attracted to the currency. After years of investing in some mediocre companies at bargain prices, Warren Buffett explained a shift in strategy by saying "I'd rather buy a good company at a fair price than a fair company at a good price."

Comparing Prospective Yields on Johnson & Johnson: Corporate Bonds, Earnings & Dividends



Note: All yields are prospective (i.e. forward-looking) annual returns based on best-available forecasts of earnings, dividends, coupons and principal repayment. The earnings yield (1) is based on the consensus earnings estimate for the next 12 months, divided by the stock price. The dividend yield (2) is based on the indicated annual dividend, divided by the stock price. Dividends can be increased, decreased or totally eliminated at any point without notice. Bond yields are computed according to convention. Past performance is not a guarantee of future results.
 Source: Bloomberg.

Given the wide range of investment opportunities to consider, we find it much easier to compare alternatives on the basis of prospective yield. Of course, with equities, a significant portion of the earnings is usually reinvested into the business, so the “cash” (dividend) yield may underestimate the total return. In any comparison, it is critical to consider three basic components of the underlying earnings stream: the rate of growth, the volatility of growth, and the sustainability of growth.

Some observers like to compare the P/E directly to the growth rate, but we think this can be misleading. Fast-growing businesses usually command a high P/E (i.e., trade at a low earnings yield), because investors expect earnings to grow commensurately. But high growth can fade quickly and is often quite volatile, and these factors prevent the P/E from rising as far as it might otherwise. Meanwhile, slower-growing businesses that are very steady (i.e. without much volatility) and those with long-term competitive advantages also command a higher P/E than companies without those benefits.

Comparing P/Es on the basis of growth rate alone can be risky, because one might become more attracted to companies offering more growth without distinguishing between sustainable growth and temporary growth, or between steady growth and cyclical growth. Likewise, one might be tempted to overlook slower-growing companies with seemingly high P/E’s, simply because they look expensive. That premium P/E may instead reflect a competitive advantage that we feel should have an opportunity to sustain an attractive growth rate far into the future. Many companies like these are “at fair prices” in the stock market today.

Tom McManus

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