

# The Week

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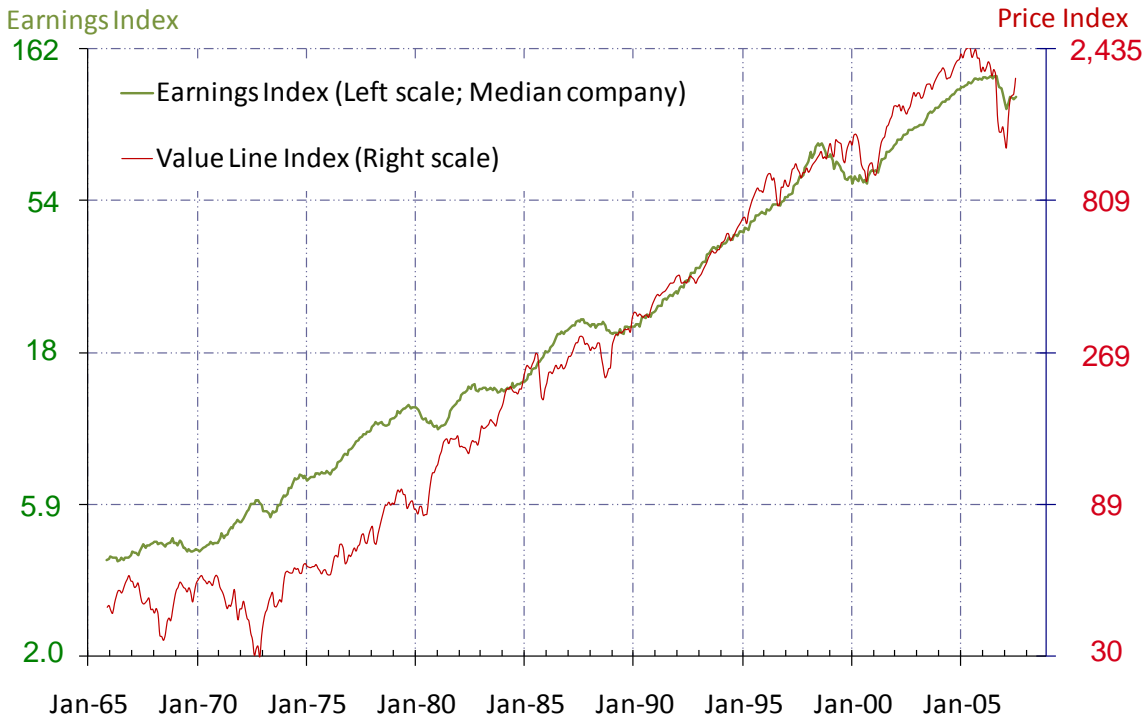
*Tom McManus, Chief Investment Officer*

## **What is the US Stock Market's Price/Earnings Multiple & Why Does it Matter?**

- We have heard several questions and comments from investors recently about the valuation of the US equity market ... and whether there is a simple way to determine if now is a good time to buy. We paraphrase one question here:
- "Today with 65% of companies' results reported for the 2nd quarter of 2009, the so-called 'Operating P/E' is only 23x according to CNBC. Some on Wall Street are saying the S&P 500 is attractively valued, so it may make sense to look past the problems our economy faces currently and recognize that a new trend is in place. But others claim the 'As Reported' P/E (this figure is based on net income actually reported to the Securities Exchange Commission via the 10Q form each quarter) is a sky-high 723x. If the previous all time high using this measure was 46x, doesn't that mean that stocks are very dangerously overvalued now?"
- Simply put, the answer is no. We do not believe stocks are overvalued relative to current profits. The median P/E multiple according to Value Line is 17x. As we see it, the problem today is the possibility that the current profit downturn will last longer and the upcoming recovery will be more restrained than recent cycles, and that today's optimism about the pace of recovery will give way to a less sanguine view.
- The first thing to know about Price/Earnings multiples is that the ratio itself is inherently unstable. Of course, stock prices cannot fall below zero, but earnings certainly can! If a \$50 stock has \$5 in earnings, the P/E multiple is a reasonable 10x. If earnings were to decline to \$1 with no change in price, the P/E multiple will zoom to 50x, and if earnings fell to \$0.10, the P/E multiple would be 500x! We should remember that dividing any number by zero is a no-no, and the "blowing-up" of the P/E ratio is a real life example of why that is so.
- Another important consideration is that — in good markets or bad — one can always find a wide selection of P/E multiples to choose from. Some stocks sport a low single-digit P/E multiple and some are in the stratosphere. In our view, it is the P/E range in the "broad middle" that determines how much value exists there. As with any restaurant wine list, you may be asked to pay a higher price for a quality selection. If you visit several restaurants and recognize a few labels in common, you can compare prices more objectively.
- Of course, investors won't pay much for the equity of a company which is never expected to make a profit, but there are two basic reasons why some stocks maintain a positive price despite negative earnings:
  1. Companies whose sales are sensitive to the pace of economic growth often find themselves with excess inventory in a recession, and usually cut production and employment in response. The cost of these adjustments sometimes overwhelms the profits from reduced production and losses ensue. For those companies who still maintain a competitive edge, investors are often willing to look past a river of red ink to green pastures on the other side.
  2. Companies that may have never reported a profit — and may not be profitable in the near future — may continue to attract equity investors based on their prospects for the more distant future. If the size of the potential payoff is large enough, and the probability associated with success high enough, investors may assign a lofty value to the equity.

## Historical Relationship Between Profits and Prices of the "Average Company"

Excludes Dividends



The Value Line Arithmetic index is an equal-weighted index of approximately 1,700 stocks in 98 industries. The earnings index is the corresponding earnings trend for the companies in the index. Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment.  
Source: Value Line.

It is useful to be able to recognize the basic difference between the two categories above, because both types of companies will appear to have very high P/E multiples. **In a weak economy, companies in the first category will be prevalent, and this will tend to increase the P/E multiple of an index like the S&P 500.** By contrast, investors can always find companies in the second category if they look hard enough, but they become more **conspicuous with the build-up of enthusiasm in an overheated market.**

Depending on the number of loss-making companies included and the size of their losses, one can easily construct a portfolio where the red ink of some businesses virtually offsets the profits of others. Thus, a P/E of 723x is an attainable but absurd result. But if you had a portfolio of 10 companies worth \$1.5mm and your share of the total profits was \$100K, your portfolio P/E would be 15x. Inserting another company that reports losses of \$50K — even if it cost you nothing — may seem as though it raises the P/E to 30x, but in reality it does not make the portfolio any more "expensive."

For some time, we have observed that setting a profit estimate for the S&P 500 is a lot easier than determining what is the appropriate multiple to pay — because the multiple depends on the contribution of a wide variety of companies and industries. Normally, investors reward sustainable growth with a higher multiple, and emphasize "normality" over "cyclicality." That means that above-average profits are usually awarded a lower multiple, while below-average profits often command a higher multiple.

Our chart shows the ups and downs for profits and stock prices over the past 43 years.

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