This May Be the Most Overused Ratio in the Investing World

Description

In investing, there is a ratio often used to determine how expensive a stock is: the price/earnings to growth ratio. The PEG ratio, as it is normally called, divides a company's P/E ratio by its growth rate. For example, a company with a price/earnings ratio of 20, but growing EPS by 10% per year, would have a PEG ratio of 2.0.

The ratio gained a lot of popularity when legendary investor Peter Lynch wrote in his book *One Up on Wall Street* that "The P/E ratio of any company that's fairly priced will equal its growth rate." In other words, a PEG ratio over 1.0 indicates an expensive stock, while a PEG ratio under 1.0 indicates an undervalued stock.

But this reasoning is flawed. Two examples, one hypothetical and one real, will show why.

A hypothetical example

Consider two companies that have the same earnings per share, one growing at 1% and the other growing at 2%. According to the PEG ratio, the second company's stock price should be twice as high. This makes no sense whatsoever; it is not worth paying double the price just to get that extra percentage point of growth.

Second, according to Peter Lynch's rule of thumb, the two companies should have price/earnings ratios of 1.0 and 2.0. This of course would actually make the two companies extraordinarily cheap. In reality, those stocks would normally have a P/E ratio between 10 and 15, and could still be considered cheap even in that range.

A real example

To put this in better perspective, consider two telecommunications companies that compete fiercely in Western Canada: **Telus** (TSX: T)(NYSE: TU) and **Shaw Communications** (TSX: SJR.B).

Both companies have very strong franchises, with subscription-based revenues that can withstand a weak economy. But each company will struggle to find growth. As a result, Telus's PEG ratio is 1.9, implying that the company is trading for twice its real value. Shaw's PEG ratio is a jaw-dropping 4.3, implying it's overvalued by a factor of 4.

But both companies trade at a forward P/E ratio of 15 times, not unreasonable for companies in this industry.

Foolish bottom line

Supporters of the PEG ratio will argue that it's not meant to tell the whole story; it should only be used as a screen to find potentially cheap stocks, and nothing more.

But even that would be too much. The PEG ratio is flawed enough that it can make cheap stocks look very expensive, just like Telus and Shaw. So when looking for new ideas, it's best to avoid using this ratio altogether.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TU (TELUS)
2. TSX:SJR.B (Shaw Communications)
3. TSX:T (TELUS)

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