Growth Stocks: Why the P/E Ratio Is Irrelevant

Description

I often hear retail investors reference a company's price-to-earnings (P/E) ratio as a measure of a company's valuation. Although it is one of the more popular metrics, it is often one of the most misused.

In of itself, the P/E ratio provides very little insight. Even more so when attempting to value growth stocks. Why? The P/E ratio is a measure of a company's historical performance. It measures the company's stock price against its trailing 12-month earnings.

Although it is helpful to gauge a company's historical performance, as a growth investor, I am more concerned about future performance.

Historical red herrings

Case in point, **goeasy Ltd.** (TSX:GSY) is currently trading at 17.2 times earnings. Benjamin Graham, the father of value investing, believed that companies should not trade above a P/E of 15. This is but one of his criteria, but a P/E of 15 is widely considered as a benchmark for the market.

As of writing, the TSX is trading at 15.9 times earnings, and the consumer financial industry is trading on average at 11.6 times earnings. To further emphasize my point, goeasy's five-year historical P/E average is 13.

Taking nothing but the P/E into consideration, investors may conclude that goeasy is overvalued.

Not so fast.

Forward P/E

Remember, we are interested in goeasy because of its expected growth profile. As goeasy has entered new growth markets, analysts have been revising estimates upwards. Over the next couple of years, goeasy is expected to grow earnings by approximately 50% annually. The company is expected to post earnings per share of $3.68 in 2018 and $4.86 in 2019, up from $2.42 in 2017.

When compared against 2018 forward earnings, the company's forward P/E ratio is only 11.5. Let's assume that at the end of the 2018 fiscal year, the company meets estimates and it reverts to trade in line with its historical P/E average. The resulting share price is $47.84 — 13% above today's share price.

Still think its overvalued?

P/E to growth

Peter Lynch, arguably one of the greatest mutual fund managers of all time, also believed in valuing companies based on expected growth rates. His go-to metric was the P/E-to-growth (PEG) ratio. He believed that a company was trading at fair value if its P/E matched its expected growth rate — in other words, a PEG of one.

A PEG below one means that the company's share price is not keeping up with expected earnings and is thus considered undervalued. A PEG above one signifies that its share price has gotten ahead of expected earnings. It is thus considered overvalued.

Back to goeasy. The company is trading at a PEG of 0.35, which is ridiculously cheap. The market is undervaluing future earnings.

The P/E ratio is a useful metric if it is not used in isolation. If used improperly, you might miss out on great investing opportunities, such as goeasy Ltd.

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