Stocks for Beginners: A Brief Tutorial on Why the P/E Ratio Is So Important

Description

If you're new to stocks, even if you've done a bit of investing before, by now you've probably come across a reference to a company's P/E ratio, or price-to-earnings ratio.

You might also already have an understanding that a company's P/E ratio is something that you should be looking at before making an investment in the shares of a publicly traded company.

However, perhaps you know it's important, and yet you still aren't quite sure exactly what it's supposed to represent or how to compare and evaluate the P/E ratio of two different companies.

In this post I'll attempt to break down what the P/E ratio really is in plain language, and why it's so important as a function of the investment process.

All the P/E ratio is doing is telling you the ratio between the price "P" you have to pay in order to buy stock in a company and the earnings "E" you're entitled to in return.

Take, for example, **Dollarama Inc** (TSX:DOL), a very successful discount retail chain.

Dollarama shares are currently trading at a price of $39.30 on the TSX Index as of this writing.

Meanwhile, the company has earned $1.60 per shareholder over the past 12 months.

The P/E ratio combines these two figures, and says that someone that wanted to become a new shareholder in the company would be required to pay $39.30 and return for $1.60 of the company's earnings.

The P/E ratio of Dollarama would then be calculated as:

$39.30 / $1.60 = 24.56 times earnings

Another way of looking at it would be to say that it would take the investor approximately 24.56 years in order to receive their money back on an investment in Dollarama shares today.

We could represent this in an equation as:

$1.60 earnings per share x 24.56 years = $39.30

Now, if you're reading this and saying to yourself, "That 24.56 years is a long time to wait to get your money back from an investment," you'd probably not be alone in that line of thinking.

Which is exactly why investors tend to prefer companies that are trading at low P/E ratios, all other things being equal.

A low P/E ratio is sending a message to the market that the company's expected payback period is shorter than that of companies with higher P/E ratios.

The caveat to this is a company whose earnings are forecast to grow over time.

Given that Dollarama continues to roll out additional outlets each quarter, this isn't usually a particularly unreasonable assumption either.

If you're expecting a company to grow at a faster rate than what's being anticipated by the markets, this could justify a profitable buying opportunity as well.

Bottom line

There are numerous factors to consider when evaluating a potential investment.

However, one thing that you'll want to keep in mind is that all other things being equal, a lower P/E ratio is usually going to be one that benefits the investor.

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jphillips